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Editors

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Foreword and Acknowledgements

This volume brings together the results of some of the trade-related research and analysis undertaken within and on behalf of the Department of Foreign Affairs and International Trade over the past year. It builds on the research base undertaken in recent years and subsequently compiled in previous volumes in this series, *Trade Policy Research 2001* and *Trade Policy Research 2002*.

The content in the first two volumes of this series reflected the debate in trade policy circles as the context shifted radically from the post-Seattle WTO Ministerial soul searching to the post-Doha assessments of prospects for the current round of multilateral trade negotiations, the ninth since the establishment of the GATT in 1947.

This year's volume continues in that vein, emphasizing issues in the multilateral trade sphere—and reflecting the atmosphere that prevails as the Doha Development Agenda moves towards its planned half-way mark at the Fifth WTO Ministerial Meeting in Cancun, Mexico, in September 2003.

This year's collection of essays and articles features a contribution from the Minister for International Trade, the Honourable Pierre S. Pettigrew. His essay "Reconciling the Spirit and Ethics of Liberalism in the 21st Century" is particularly timely. It celebrates the spirit of liberalism which has intellectually underpinned the internationalism that fashioned the post-WWII international rules-based framework and underwrote the unprecedented expansion of trade and investment over the past half-century on which so much of today's prosperity depends. Today, at a time when doubts about the future of multilaterism as we have known it dominate discussion, his message sounds an important counterpoint.

Part I of the current volume addresses the issues confronting the Doha Development Agenda, the constructive tension between competitive regionalism and multilateralism, and the evolving consequences for international trade of the post September 11th security environment. These chapters collectively emphasize the risks that prevail in the current international environment, risks which need to be countered with creativity and strengthened international collaboration.

Part II addresses systemic issues that confront global governance, including the handling of trade-related intellectual property as well as the functioning of the dispute settlement regime and the decision-making bodies of the World Trade Organization.

Part III presents a series of essays commenting on aspects of the social dimensions of globalization, including the scope for social choice in a globalized world, the questions raised by divergence of incomes between the rich and the poor, and the contextual factors that might explain the episodic nature of countries joining the "convergence club"—i.e., entering into a rapid phase of development that allows them to eventually catch up with the rich.

Through this volume, we hope that the Department continues to contribute actively to the development of policy thinking concerning international trade and investment and its role in and impact on the global economy. And, in the process, we continue to work in the spirit of the broader commitment of the Government of Canada to stimulate the development of its research capacity. Accordingly, the papers are written in the personal capacity of the authors and do not represent the views of the Government of Canada or its Departments. At the same time, we continue to foster links with professional and academic commentators by continuing the pattern set in previous *Trade Policy Research* editions of including contributions from that quarter.

This volume was produced under the guidance of John M. Curtis, Senior Advisor and Co-ordinator, Trade and Economic Policy, at the Department of Foreign Affairs and International Trade (DFAIT), together with co-editor Dan Ciuriak, Senior Economic Advisor, Trade and Economic Policy and Trade Litigation. Alexander Muggah provided research assistance and copy editing. Mira Patel managed and coordinated production.

I am indebted to these officers for their efforts in achieving this trade policy research volume.

Leonard J. Edwards
Deputy Minister for International Trade

May, 2003

Preface

Reconciling the Spirit and Ethics of Liberalism in the 21st Century[*]

Isaiah Berlin helped shape my belief that liberalism embodies the ideals of generosity, openness and tolerance—of seeing diversity not as a threat to identity but as an opportunity to deepen it. This defines Canada: I see Canadian values, particularly those of confidence and conscience, the two essential pillars of liberalism, as a reflection of liberal values.

From this perspective, the emblematic figure of Isaiah Berlin constitutes, in my view, a source of incomparable inspiration. One need only read "Freedom and Its Betrayal," a compilation by Henry Hardy of famous radio lectures that Berlin devoted to six enemies of liberty: Helvétius, Rousseau, Fichte, Hegel, Saint-Simon and Joseph de Maistre.

Today, freedom is under major threat, even from those who would claim to be its servants. However, just as Berlin's dire reminders caution us to be wary about loss of freedom, so too do his positive reflections on the nature of liberty invite us to be ingenious in its promotion.

In this regard, Berlin's newer work, assembled by Henry Hardy in "Liberty," provides a salutary lesson that we urgently need to adapt for our own time. Liberalism, as embodied so well in the figure of Berlin himself, has to discover the tragic sense of human existence and at its core, the practice of freedom.

Freedom ceaselessly forces us to choose between competing values that are not necessarily equivalent—that sometimes are reconcilable, but often not. We are at a juncture where choices of the latter kind are before us.

The ideas encapsulated in market fundamentalism—privatization, deregulation, free trade and reduction of the role of government in ensuring equitable outcomes—have met with support in some liberal circles and indeed to some degree have been championed by me in my present role as Minister. However, if implemented dogmatically, they represent a very conservative approach to political economy (erroneously named neo-liberalism), which brings with it certain dangers, as do all dogmas. Indeed, today these ideas form part of the so-called "Washington consensus" which effectively says, "if you do all of these things, in all circumstances, in every country of the world, you will meet with success." It is more complex than that, and I believe Isaiah Berlin knew this as well. To every particular problem you have to find an appropriate solution.

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[*] An earlier version of this essay was presented as the Isaiah Berlin Lecture, London, England, January 20, 2003

If we reduce the human being to a consumer, a producer and an economic actor, we miss the whole spiritual dimension of human existence. As a liberal, I feel that it is imperative that human freedom and the ability of the individual to develop, to grow and to fulfil his or her destiny be central to our vision of society. Accordingly, equality of opportunity must remain a key liberal objective.

In my view, just as Marx's materialist philosophy denied all metaphysical aspects of existence by reducing the human being to a mere economic player, the market fundamentalism at the heart of the Washington consensus has made the same error; its vision is far too simplistic and reductive. If we interpret and seek to control the behaviour of markets in terms of hard scientific laws we commit the same colossal error as Marx did with his theory of historical materialism. For, in the end, it is the human being—not some scientific pretension—that is the driving force of history.

That is why I turn with no hesitation toward liberalism. Liberalism is the most humane perspective there is, and the one best suited to guide us as we adapt to the rapidly changing world in which we find ourselves.

Liberalism and the Balance of State and Market

Liberals, and liberalism, have contributed substantially to that immense progress over 350 years that has resulted in what we appreciate as modernity. Indeed, the combination of balance and dynamism that has been central to the liberal approach has also been, in my view, at the heart of the extraordinary miracle of progress, because development remains the exception on our planet. This miracle was made possible by the constructive "tandem" of the state and the market, a relationship that has been fashioned by liberals. Indeed, highly developed markets would not even exist if there had not been a state to guarantee property rights and other individual rights in this very country.

The United Kingdom and the Netherlands were the first countries where individual property rights were recognized at the level of a national market and where the modern economy first emerged. The emergence of national markets, and then of industrial economies, required the breakdown of the stifling barriers to commerce and economic flows that were embodied in the entrenched mercantilist restrictions of cities at the nation-state level and of the empires at the international level. Economic modernity thus involved the weakening of the traditional allegiances that impeded the logic of the marketplace, and the introduction of a social division of labour.

The state-market relationship is a dynamic one and, in my view, we are just as wrong to want to eliminate all government intervention in favour of market forces, as were those in the communist countries who suggested that government should make all the decisions. Here, more than anywhere, a search for balance is indispensable.

As an abstract entity, the essential goal of the state is legitimacy—that is, the deliberate quest for that which is fair, reasonable and equitable. The time horizon of the state and of its instruments—its laws and constitutions—is the long term. The state makes privileged use of constraint. This is the realm of conscience.

As for the market, it responds as well and as quickly as possible to the consumption and production needs of societies. The market has, as its essential objectives, efficiency and profit. Closer to instinct and desire, it does not share the time horizon of the state: its time horizon is short—that of imperious immediacy. This is the realm of confidence.

And so, it is clear that the state-market relationship is highly important, and the need to maintain balance will not disappear. In fact, this balance is essential to liberalism, and its *mode of production, capitalism. For this reason, the rule of law* is the essence of liberalism.

We have seen this past year examples of the type of excesses that can occur when market actors ignore state regulations and act without conscience. The New York Stock Exchange saw share prices plummet following the revelation of the ethical failures at Enron, Worldcom and others. Investors lost confidence when they sensed that their trust had been misplaced or abused. For confidence to continue to be the engine of progress, we have to make sure that it is accompanied by an ethic of conscience. The two must go hand-in-hand; our system requires that the public conscience be respected.

Culture of Excess Must Give Way to Commitment to Sustainable Prosperity

The limitations of modernity underscore, in my view, the importance of stronger ethics. In turn, the need for stronger ethics provides a major role for liberals in helping our civilization move into post-modernity.

Modernity has been, of course, a great boon to those who have had the privilege to experience it. Consider, for example, that we have vanquished many of the epidemics that killed millions around the world for centuries and that infant mortality rates have been substantially reduced.

And yet, economic, social and even physical security is still not assured for all. For example, we have not been able to achieve a multilateral agreement to ensure that the poorest of the poor have access to essential medicines. And, unfortunately, we still face difficulty in avoiding the genocide and other atrocities that have occurred in such places as Rwanda and Kosovo.

Moreover, the progress that has been made in the era of modernity has also had an effect on our size. Whereas there were one billion human beings on the planet in 1850, there were three billion when I was born in 1951. Today, we are six billion; some estimates suggest that there will be around ten billion people on earth by the end of this century.

If we look, in this context, at the culture of excess that modernity has spawned, we see that we are in deep trouble indeed. While it is true that the "limits" of the planet have not yet been reached, our planet's resources are not infinite. As our population grows to 10 billion, and as prosperity finally spreads throughout the developing world, we will have a critical problem if consumption continues to grow at the same rate and with the same pattern as it has over the past 150 years.

It is my desire that we have not just sustainable development but a sustainable prosperity. Modern society's culture of excess—which was spurred by the confidence of the past—must give way if we are to achieve this goal. Building wealth is an objective all nations can share, but this process needs to be undertaken with a conscience if it is to bring truly sustainable prosperity. Choices will have to be made.

For instance, the production of just one kilo of beef requires 2,000 square feet of land and 100,000 litres of fresh water, a precious and scarce natural resource. In comparison, the production of one kilo of soy—which yields comparable nutritional value to beef—requires less than one percent the amount of land and less than one percent the amount of water.

Under current conditions, how can we persist in our dietary habits? And, if we are going to have one billion cars and SUVs on the planet with all the pollution that this entails, we have another problem.

Development is a product of confidence, but we also need to develop a conscience to enlighten our consumption and assure that it does not become unrestrained.

I am very committed to the WTO's role in achieving sustainable prosperity. I believe that the current round of WTO negotiations—which is referred to as the Doha Development Agenda—will help to spread development and prosperity and the rule of law. But we must also make certain that this progress occurs in a sustainable manner.

Confidence is important in an economic sense, but there is more than that to our common humanity. We need an ethic of consideration and care that goes beyond the administration of justice that we have experienced in modernity.

The Tragedy of the Global Commons

Without question, reason has enabled us to achieve many remarkable feats. However, the powers it develops cannot be divorced from the responsibilities that are their necessary corollary. In my view, the fulfilment in psycho-neurological terms of the present potential of the human brain—if realized without the ethic of care—will lead to dire consequences.

The problem can be posed this way: we human beings have used our innate intelligence to attain a level of knowledge that now enables us to act upon our environment to an extent that the consequences of those actions are often beyond our ability to control. From the standpoint of our species, enterprises such as the development of our informatics capacities or artificial intelligence research are intended to make up for this phylogenetic shortfall, for no one knows when we will be biologically "caught up" in this regard. In other words, as human beings, we have "evolved" so much that we can now cause serious problems that we are manifestly unable to solve (at least, at the moment).

For example, we can spill millions of litres of oil into the sea but we are relatively impotent or inefficient when it comes to repairing the damage. We are producing more food, but cannot prevent one part of the world from suffering from famine and the other from obesity, cholesterol-related cardiovascular disease, and so forth. We have refined water treatment technologies, but one part of the world still lives in drought zones while another wastes water without even thinking about it while brushing their teeth, preparing food or maintaining a golf course in a desert.

We can now intervene on the genetic code, and are even preparing for bioengineering that targets nothing less than the whole of the human genome, but we know almost nothing about the consequences of the transformations that might flow from such interventions. We have been able to create formidable weapons—e.g., chemical, atomic, biological—but have difficulty ensuring their control and limiting access to them.

In short, more than ever, we find ourselves in the position of the sorcerer's apprentice!

A way of expressing the idea of the responsibility that accompanies the exercise of the great powers afforded us by reason is nothing other than conscience: for, indeed, how can we feel the weight of the responsibility that accompanies power if we have no conscience—if we are neither aware of, nor care about, the consequences of our actions? And, *mutatis mutandis*, what is true for the individual applies also to societies.

This conscience, or ethic of caring, must be applied throughout society, at every level: government, corporate and academic, with the individual as the foundation. The reason is straightforward—the paradox that lies at the heart of what is termed the "tragedy of the global commons", namely the effect where the pursuit by each individual of prosperity undermines the common basis of that prosperity.

The significance of each individual's shift toward a new consciousness cannot be overstated: the current situation is of an urgency rarely encountered in human history. The individual is now in a situation where his or her smallest private decisions—combined with those of others, of course—can bring about veritable catastrophes. And, it is not just people in wealthy societies who too often abuse our planet—for example, by operating gas-guzzling vehicles; adding to the scale of the problem is the behaviour of individuals in developing societies who adopt the lifestyles of those in rich societies, and often do so without recognizing the need to use new technologies to avoid pollution.

Consciousness Raising: Building the Momentum

But the story here is not all doom and gloom. There are individuals who have adopted and demonstrated this ethic of conscience, individuals from whose actions we can derive momentum, until the ethic of conscience becomes an integral part of each individual's decision-making process. More and more individuals are volunteering in their communities. In Canada, for example, 7.5 million people—nearly one in three—volunteer their time. More people are choosing to take public transit, recycle, use fewer pesticides, and buy ethical funds rather than regular mutual funds.

There is increased evidence of responsible corporate behaviour. At the Pierina Mine in Peru which I visited last fall, the Toronto-based company, Barrick Gold, is focusing not only on revenue, but on community development, by helping to provide education (notably for girls) and training for the local population.

Meanwhile, scientists around the world have been working on genetically engineered products to help a greater number of people produce more nourishing food. For example, a product called "Golden Rice" has been engineered to address vitamin A deficiency, the leading cause of blindness among children in developing countries. In India, they have developed a genetically engineered "pro-tato" that will be disease resistant and yield greater crops.

Governments, too, have been showing an increased sense of conscience. As International Trade Minister, I can point to the labour and environmental side agreements to our NAFTA, as well as to our commitment to both greater transparency and broader development in the new WTO round and in the ongoing Free Trade Area of the Americas negotiations. I am also proud to be part of a government that has ratified the Kyoto Protocol.

All of these examples point to more socially responsible behaviour inspired by a greater sense of conscience. This is a good start, but if we want to enjoy truly sustainable prosperity, we must be committed to making all of our respective choices in light of an even higher degree of conscience. And, if we want this ethic of conscience to permeate all levels of society we must ensure that individuals use their power, particularly in democracies, to influence the state and their society. Too many believe they can't make a difference.

The Role of Politics

Political involvement has been in decline as public trust in political institutions has diminished. In Canada and in most Western democracies we lament the lower voter turnout election after election. As liberals who believe in democracy, we must work to restore the desire of individuals to engage in and contribute to the political process. We have to fight the widespread cynicism of so many about the present political debates. We have to re-instil confidence in public leaders and the role of government.

Moving beyond the political passions to the ethical passions that animate today's actors in the civil society movement will contribute a lot to re-instilling this confidence in the role of politics and of government. The political project must aim to re-establish conscience in its appropriate place alongside confidence in the liberal philosophy. This will create a space where conscience will inform confidence, the driving force of modernity. That space will allow for a dialogue with engaged citizens who have turned their back on politics. Liberals and democracy both need this dialogue. For, it must be acknowledged that the triumphs of confidence have recently led to the narrowing of conscience—I thus hope for the emergence of ethical passions.

As we respect the intelligence and interest of citizens, we must counter the "dumbing down" of political discourse and both modernize and actualize the issues central to this era of revolutionary change. I believe this very liberal political project will connect us with many who have abandoned the field of politics. It will re-engage individual citizens in the crucial role that politics plays in shaping our society.

We have to move beyond the political passions of the 19th and 20th century that focused a great deal on social advancement and national liberation movements. Both were important engines of history. Both of these political passions brought forward groups, mostly led by men. It is no accident that many newer social movements are for the first time being led by women, whereas the union movement and national liberation movements were and still are mostly headed by men. I believe the leading role of women in the emerging society will inevitably strengthen the ethic of caring, because in centuries past, men have been more responsible for the emergence and endurance of the ethic of justice, as feminist literature well-describes.

It has long been thought impossible to move beyond commutative justice based on retribution, reparation of wrongs and the punishment of crimes. Post-modernity is proving otherwise, as strikingly illustrated by the work of the Truth and Reconciliation Commission in South Africa, in which we saw unvarnished truth about past injustices, undertaken with a view to reconciliation, rather than to vengeance or punishment.

In Canada, this ethic, long central to the aboriginal tradition, was recently evoked in a dialogue among Georges Erasmus, John Ralston Saul and Alain Dubuc on the occasion of the publication of the Lafontaine-Baldwin lectures. Each municipality in Nunavut has community freezers where leftover meat and fish are stored. The whole community contributes and people can help themselves as needed. There is no administration or papers to sign: there is thus no humiliation. The Dene community has developed a very similar model for distributing meat. It is not charity. It is simply extra food that is made accessible to all, according to their needs.

Shedding its light from Southern Africa to Northern Canada, this example of the ethic of care is rooted in distributive justice and rests on altruistic considerations: the determining factor is not whether one has a "right" to something, but an emphasis on meeting one's need in a respectful manner.

It is time to move beyond the great message of the philosophers of the Enlightenment where reason meant a belief in progress and justice. Now, more than ever, we need to consider how to reconcile our confidence with a conscience, which will require tough choices. But this reconciliation, in my view, is central to liberal political objectives.

American Supremacy and the New Conscience

The United States has attained a predominance unequalled in the history of humanity. Its government has unparalleled power and its society has extraordinary wealth and capability. Thus, the American hegemony extends in various ways into the private lives of every individual, and into their very homes, notably via radio and television. The sounds of American music and the images of American media (and values as well) dominate our leisure time.

If the political task I see as crucial to the future of the planet is to succeed, we need this reconciliation of confidence and conscience to take place especially in the United States, given its extraordinary influence.

In many instances in its past, the United States has been up to the challenge, even if at times it has been the subject of criticism both inside, and recently, outside the country. Consider that the United States, within the past year, has made its firefighters heroes, just as it has jailed its corporate icons of the 1990s. So, the United States has shown that it can make such an important shift.

Consider Time magazine's Persons of the Year for 2002. They were not business or government leaders, nor were they men. They were the three female whistle-blowers who tried to warn Enron, WorldCom and the FBI about the problems looming on the horizon. That is a sure sign of the growing sense of conscience in the United States. While conscience has been part of the United States' ethic in the past it is one that we need to see even more of in the future.

In the United States, nascent capitalism was marked most by the austere Protestant ethic, by the asceticism of accumulation, by long-term work and by a concern for the benefit of the whole community. It was not simply "get rich as fast as possible and ignore the rest." The nobility of the motives and objectives of the country's founders—fleeing famine, disease and war, and wanting to build a new, classless society—continue to constitute the framework of American public life.

It was in the United States that Franklin D. Roosevelt developed the New Deal that gave birth to the Providence State. The New Deal was a brilliant example of energetic liberalism, the audacity of which salvaged capitalism following the stock market crash of 1929 and the Depression of the 1930s. In retrospect, no one doubts the contribution that the Americans tried to make at the Conference of Versailles in 1919: the famous Fourteen Points of President Woodrow Wilson. After World War II, the Americans made an extraordinary contribution through the creation of the Bretton Woods Institutions, the Organization for Economic Cooperation and Development (OECD) and the United Nations.

At the same time, it is nonetheless regrettable that the United States has not ratified the Kyoto Protocol, the International Criminal Court and the Ottawa Convention banning anti-personnel mines. We must recognize, however, that no country in its time of predominance has ever readily accepted limitations on itself in a multilateral arena. Furthermore, one can only note with irony that, when Americans act internationally, they are charged with being arrogant unilateralists; yet, when they decide not to intervene, they are accused of egotistical isolationism!

The United States, however, continues to have a choice between coercion and persuasion. If they use force—military or other—in a manner that is deemed to be too willing or eager, they will almost certainly succeed in the short- to mid-term. In the longer term, however, they would likely face a growing number of hostile states or groups. This is, of course, both an undesirable and likely unsustainable route.

The alternative, of course, is to use a more subtle approach, which relies less on military and economic might, but more on international leadership based on consensus, and on their solid values that have had such extraordinary appeal to so many on all continents. Accepting this approach would mean that Americans would have to accept not having their way every time and everywhere.

In the longer term, however, this "softer" approach would likely earn increasing respect and the goodwill that accompanies genuine respect. I often tell my American friends that they must not go around the world gaining their way by sheer force of their "might". It must be tempting, given their undeniable predominance, but with great power comes great responsibility.

The alternative involves translating their values and their objectives into institutions that will promote their interests long into the future. The great victory over Soviet communism is due, in my opinion, to the depth of our liberty and the institutions and values that have permitted us to build a society where both economic and social development are inherent parts of the cultural fabric.

Conclusion

This is our shared project at the dawn of the 21st century. I am convinced that we are entering into a new civilization. I believe that it will be a post-modern civilization. I want liberals to be at the heart of it as much as we have been at the heart of modernity. Our duty is to ensure an emphasis on the reconciliation of the spirit and ethics of liberalism, that is to say, between confidence and conscience. Liberals have a perspective that can help us respect the values of north and south, of the privileged and the less privileged. We must always remind ourselves that the whole purpose of the exercise is to allow people to fulfil their ambitions and to foster happiness.

It is a great privilege to share my convictions with you. To those who tell me "Minister, you dream in colour; it is impossible to reconcile ethics and the spirit of liberalism; it is too late," I say "NO." Not only is it not unthinkable, actually it is inevitable; inevitable because when conscience dissipates, confidence collapses. Reconciling the two is the political task of our generation.

Pierre S. Pettigrew
Minister for International Trade

May, 2003

Part I

The Evolving Context for the Multilateral Trading System

Towards Half Time in the Doha Development Agenda

John M. Curtis and Dan Ciuriak

On March 13th-14th, 2003, the Department of Foreign Affairs and International Trade convened an informal meeting of leading observers of the international trade and investment scene for a discussion of the progress of the Doha Development Agenda as it moves to its planned half-way mark at the Fifth Ministerial of the World Trade Organization (WTO) at Cancun, Mexico, in September 2003. The broad objective of the workshop was to obtain views on the prospects for this Round, taking into account both the negotiating agenda and the geopolitical and international macroeconomic context, to discuss emerging issues that might need to be addressed and/or cross-currents that might affect the direction of the negotiations, and to identify areas where analytic work might facilitate further progress. This note represents the Chair's thematic summary of the discussions; as these were held under Chatham House rules, no attribution is given. Responsibility for the interpretation of the discussion rests entirely with the editors of this volume. The usual disclaimer applies: the views expressed here are not to be attributed to the Department of Foreign Affairs and International Trade or to the Government of Canada.

Scene Setting

While the process of negotiating multilateral trade rules feels to its practitioners to be something of a world of its own, the trade system itself is nested in an often turbulent geopolitical and international macroeconomic setting, which often determines how much, and how fast, progress is made. The necessary corollary of the importance of the events of September 11th, 2001 in helping propel the launch of the Doha Development Agenda two months later is that the economic context and the stage of incubation of trade issues (including establishment of the intellectual basis for next steps) were not of themselves sufficient to launch the Round or to ensure forward movement of the negotiations once launched. By further setting a tight deadline for results, and adding a complex development dimension to the remit, Ministers implicitly set forth a very difficult set of challenges to negotiators, both in terms of preparing the agenda for the mid-term Fifth Ministerial of the World Trade Organization (WTO) at Cancun, Mexico, September 2003, and for completion of the Round in time to permit the implementation of the results by January 1st, 2005. How are the negotiators coping in these circumstances, what are reasonable expectations for the Round taking into account both the issues involved and the context, and what additional research might be undertaken to help provide the information base required to forge a consensus?

The state of preparedness for Cancun

Overall, some fifteen months into the process since the launch at Doha and with six months to go to the Ministerial at Cancun where the Round reaches the planned halfway mark, there is a general sense that, all things considered, the Round has evolved rather quickly. Good progress has been made in setting up the infrastructure for negotiations and clarifying the approach, in the process of tabling offers and requests, and so forth. Several negotiating groups have missed deadlines,[1] with slippage in the

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[1] Editors' note: The Council on TRIPs was unable to meet the end-2002 deadline under paragraph 6 of the Doha Declaration on TRIPs and Public Health to find a solution to the problems countries face in making use of compulsory licensing (i.e., allowing the use of a patent without the consent of the patent-holder) if they lack appropriate manufacturing capacity. The Chair's draft proposal of December 12th, 2002 failed to forge a consensus.

Meanwhile, the Special Session of the Committee on Trade and Development missed three deadlines (July 31st and December 31st 2002, and February 10th 2003) to provide recommendations to the General Council on Special and Differential Treatment (SDT). The some 155 SDT provisions in the WTO Agreements provide more favourable treatment and greater flexibility of timetables in meeting obligations. The impasse is over the pivotal agriculture talks looming. Nonetheless, even in these issue areas, there seems to be general agreement to move things as far as possible to allow Ministers to crystallize the agenda at Cancun. The key, from the perspective of the negotiators, is to be able to advise Ministers what should be in and what should be out and how much progress has been made on the former.

Important factors shaping the negotiations include the front-end-loaded nature of the development agenda (including the provision of technical assistance to support participation of developing countries in the negotiations) and the "soft launch" of the Singapore Issues.[2] Perhaps the biggest challenges, however, are to reconcile the differing levels of ambition amongst the Members and to resolve the difficult issues of Special and Differential measures and Uruguay Round implementation, discussions on which have become largely dysfunctional in part because the issues have become blurred.

Not unusually for the early stage of a round, the negotiating parties are still far apart on many issues. The big question is whether industrialized countries can translate their desire to support development by granting market access in areas where developing countries are competitive. And here, clearly, the core economic agenda is centered on agricultural trade. The expectation is that negotiating modalities in this key area will be

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interpretation of paragraph 44 of the Doha Declaration, which states that "all special and differential treatment provisions shall be reviewed with a view to strengthening them". Developing countries see this as opening up the text of the WTO Agreements; developed countries are of the view that the basic texts can only be changed through new negotiations involving an exchange of concessions. The criteria for differentiation and graduation (providing different levels of flexibility for countries that are in different stages of development) are also proving to be a sticking point in the negotiations.

[2] Editors' note: The Doha Declaration did not formally launch negotiations on the "Singapore Issues" (investment, competition policy, trade facilitation, and transparency in government procurement), leaving that decision to be taken, by explicit consensus, at the 5th Ministerial Meeting in Mexico. The term "soft launch" reflects the differing views on the nature of the decision to be taken at Cancun—an up or down vote on formal inclusion in the negotiations, or automatic inclusion.

decided before Cancun; however, there is less certainty that the parties will be able to identify a "level of ambition".

In the non-agricultural market access negotiations, the main issue is deciding on a formula for tariff cuts, a debate which is intertwined with the issue of level of ambition. Some formulae impose larger cuts on higher tariffs; others leave open the possibility that, depending on the level of ambition, applied tariffs would be little affected as most of the action would be in reducing tariff bindings down towards applied rates.

While the services discussions have been fairly low key so far, progress has been reasonably good in terms of requests being tabled with a smaller number of offers expected to be tabled by the deadline of end-March. The more complex "horizontal" issues with respect to services (e.g., inclusion of measures dealing with safeguards or subsidies) are less well advanced. Some developing countries are linking services offers to progress in agricultural discussions and other issue areas, but others are not making such linkages, which is encouraging negotiators that progress will be made in this area

On the technical issues, dispute settlement, anti-dumping and subsidies discussions are engaged. Where linkages are being made to other issues, the context was thought to be more negative than positive, however. Whether the Singapore Issues will be dealt with as a group or individually remains unclear.

Are the timelines for the Doha Round realistic?

Many think the timelines for the Round are too tight. Indeed, some argued that it was premature to have started the Round at Doha; enough thinking had not yet been done.

Slippage in the timetables for negotiating groups is not, therefore, much of a surprise and by the same token not very worrying. The looming risk is that a large and complex agenda will be remitted to Ministers at Cancun, much as happened at Seattle. Since the extension of a round is not to be equated with its demise (it was noted that previous rounds were pronounced dead several times as targets slipped), some expressed the cautious view that it would be wise to "get ahead of the curve" and to start managing expectations for a modest outcome at Cancun to avoid a "train wreck" as happened at Seattle.

From this perspective, the main question that emerged is how to shift expectations from a conclusion at end-2004 to a wrap up in the 2006-2007 window when several developments (including expiry of the EU CAP extension and the US Farm Bill) create an opening for movement and the expiry of US Trade Promotion Authority (TPA) forces negotiators' hands.[3]

The counter view was that, although setting an early deadline for the completion of the Doha Round might have been an unfortunate decision, it is there now and must somehow be dealt with. Moreover, if the deadline were to slide to the 2006-2007 timeframe, it was argued, there is the risk that there might be a new US Farm Bill and a new EU CAP extension, pushing resolution of the agricultural issues off for the balance of the present decade. In other words, the world community should not miss this current window of opportunity, if at all possible.

The over-arching question is how the international economic and political context will affect the progress of the Round. Will the US-Europe political rift undermine their ability to exercise their customary joint leadership on trade? Or, conversely, will trade serve as a rallying point to mend fences and to restore confidence to a faltering world economy?

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[3] Editors' note: US TPA expires June 1st, 2005 but will be extended automatically until June 1st, 2007, if neither House of Congress adopts a resolution opposing extension (www.tpa.gov). The US Farm Bill of 2002, which increased overall budgetary assistance to farmers by $180 billion from 2002 to 2012, is set to continue through 2007 (www.usda.gov/farmbill); all trade and aid programs were specifically reauthorized through 2007 (http://www.ers.usda.gov/Features/farmbill/titles/titleIIItrade.htm).

In the context of EU enlargement, the European Council agreed, 24-25 October 2002, on a farm finance package for an enlarged membership. According to the formal conclusions, the deal was "without prejudice to future decisions on the CAP and the financing of the European Union after 2006", and to the outcome of the CAP mid-term review and to the EU's international commitments in the Doha WTO Development Round." http://europa.eu.int/comm/enlargement/docs/newsletter/weekly_291002.htm Bulgaria and Romania are expected to be joining other central European countries in acceding to the EU in 2007, requiring changes to the CAP program, affording a window of opportunity for more general reforms that could also then accommodate a WTO deal.

Reading the international political tea leaves, some saw a silver lining to the cloud raised by the Iraq crisis; namely that it could put a big premium on success in the multilateral negotiations. For example, it was observed that there had been a noteworthy shift of France's public commentary on agricultural subsidies, suggesting that perhaps movement might be possible well before 2006 as was previously the stated firm position. Some were tempted to interpret this as flexibility provoked by concern over the trans-Atlantic rift.

On the other side of the Atlantic, however, some saw a risk of erosion of political support for trade liberalization in the US political system. The House of Representatives is sharply divided and the Bush Administration, TPA in hand, is expending political capital elsewhere than on generating a centrist consensus on trade. It was also suggested that the backlash in large parts of the world against intellectual property is undermining support for the round within the US business community (the technology sector, pharmaceuticals, etc.). The US system, it was argued, responds to individual issues and, outside of intellectual property, there are no big individual issues at stake. If the Round were prolonged beyond end-2004 as planned, the political calculus would also have to take into account the views of potential Democratic Party candidates, who tend not to be strongly pro-trade.

How the politics will play out is unclear. It was observed that geopolitics and the international economic situation are not obviously working positively in the short run (for example, it was questioned whether the upcoming G7/G8 meeting in France in June 2003 would be conducive to a breakthrough given spillovers on trans-Atlantic relations from the impasse over Iraq; divisiveness at this level could carry over to Cancun). However, it was also argued that, in the longer-term, there are powerful forces pushing for a solution to the issues, which provides some basis for optimism.

How important is success—and especially early success—of the Doha Round?

Some observers drew a distinction between the functioning of the WTO and the trade system on the one hand and whether or not progress is made in the Doha Round on the other.

Thus, it was argued, while the Doha Round may face complications, the system continues to work well. As an institution, the WTO is fulfilling its function: it is attracting an expanding membership (most recently and most notably China) and has demonstrated success in bringing "inside the tent" conflicts that in the 1970s and 1980s had taken place outside the GATT framework. For example, the EU-US dispute over the US Foreign Sales Corporations (FSC) tax measures was brought to the Dispute Settlement Body; this was a replay of the GATT-era dispute over the similar Domestic International Sales Corporation (DISC) tax measures which was handled bilaterally. The same is true of other EU-US issues, even if they remain to some extent unresolved. Moreover, we are not seeing the emergence of openly protectionist measures such as voluntary export restraints (VERs) or aggressively unilateral behaviour as we did in the pre-WTO days. While there are problems in the system, these were seen by some as not being so bad; in any case, it was pointed out, business has managed to "privatize" many trade issues of immediate concern (e.g., multinationals that want to use developing countries as an export base deal directly with the governments involved in order to resolve technical issues such as those addressed under the Sanitary and Phytosanitary Standards and Technical Barriers to Trade agreements). Accordingly, some questioned: whether it mattered if the Doha Round concluded in 2005, 2007 or 2010? Politicians, it was suggested, can sense this and that undermines any sense of urgency.

Seen this way, early success—or even much success in an extended timeframe—is not necessarily all that important (it was even suggested that it would be better if the Doha Round petered out, with perhaps conclusions being reached only in agricultural negotiations, while we all took the time to better understand the issues and the possible eventual bargain).

But others disagreed that it is possible to divorce the Doha Round outcome from the issue of continued effectiveness of the multilateral system. They argued that there are several potential instabilities in the system: non-implementation of panel recommendations, friction over implementation of Uruguay Round commitments by developing countries, and the related problem that agriculture was only partly completed in the Uruguay Round and a follow through is key to completing that deal. These sources of instability need to be addressed early, it was argued, in the Doha Round.

The impasse over TRIPs and public health was identified as another immediate flashpoint which could be a make or break item leading up to Cancun (and perhaps even beyond, given the role of this issue in eroding essential public support for the trade system worldwide).

Another concern raised was that competitive regionalism and bilateral deals are putting the central Most Favoured Nation principle at risk and creating constituencies that will resist further multilateral liberalization. While regional/bilateral arrangements continue to produce interesting experiments in rulemaking that might serve as templates for an international agreement (e.g., the FTAA work towards an investment code), other aspects are more worrisome (e.g., it was argued that the web of bilateral agreements on textiles in the western hemisphere is creating a constituency for preventing a rapid phase-out of the Agreement on Textiles and Clothing and indeed tending to set up a hemispheric regime that would shut out other producers). Some expressed concerns that regionalism in Asia (e.g., India and China courting ASEAN) might result in more discriminatory deals than regional pacts in Europe and North America. These potentially worrying developments, it was argued, underscore the importance of multilateral liberalization to minimize the distorting margin of preference that can be offered in such deals.

Some were of the view that what matters for developing countries is not the structure of the preferences but the increased ability to attract investment to drive development—Intel into Costa Rica being a prime example. Prior to the WTO, it was argued, the impediment to market access in the developing countries was usually lack of commitment; now it is lack of implementation. Seen against this background, the US policy to push bilateral deals is fundamentally about using access to its market to promote market development and democratic development in developing countries.

Finally, there is some concern about the expiry of the so-called "peace clause" (an agreement not to bring agricultural issues to WTO dispute settlement prior to 1 January 2004).[4] It was suggested that the EU and US might decide to address their bilateral agricultural issues through WTO dispute settlement, adding to the political pressure on this still-young institution. It was also observed that the peace clause is not necessarily only an issue for the US-EU relationship: developing countries might well start to bring cases against both!

Can development be addressed through the trade system?

By labeling the Doha Round a "development agenda" (which some saw as an attempt to co-opt the priorities of the anti-globalist movement but others as a building block for the future), the objectives of the Round were nominally broadened well beyond the normal mandate of past trade negotiations.

From one perspective, the WTO is not a development organization and has neither the institutional resources nor the writ to do much beyond promoting or undertaking rather narrow technical assistance.[5] The stress on the WTO's institutional capacity will get worse if all parties accept all obligations, it was argued—the slogan used to be "trade not aid", but with the increasingly complex rules that are emerging and that necessitate additional trade-related technical assistance (TRTA), it is becoming "trade *and* aid." At the same time, developing country trade representatives in Geneva are not those with development authority, nor are they necessarily well plugged into their countries' development agendas. By the same token, some at the workshop questioned how seriously the diplomatic process emerging in Geneva in imitation of UNCTAD was to be taken? Nonetheless, others observed, poverty reduction is now, for better or worse, in the WTO.

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[4] Editors' note: The so-called "peace clause" (Article 13, "due restraint", of the Agriculture Agreement) precludes challenges being mounted against a country's agricultural subsidies under the WTO's Subsidies and Countervailing Measures Agreement. The clause expires at the end of December 2003, unless extended, which would require consensus.

[5] Editors' note: Given the WTO's limited capacity, and the many commitments under the Doha Development Agenda, the General Council subsequently established the Doha Development Agenda Global Trust Fund and expanded funding for technical assistance by 80 percent.

More deeply, some feared that the Round is set up for failure, if it cannot deliver on the very difficult objective of development. Development is not very well understood, with views about appropriate approaches differing considerably. Practitioners have found it necessary to approach development issues on a case-by-case basis, tailoring programs to individual circumstances and adjusting the conditions tied to assistance from one agreement to the next as things are found to work or not to work. As was pointed out, this is not exactly an approach suitable for an organization trying to set multilateral rules.

And more deeply still, some thought that the development theme serves to further muddy understanding of the purpose of the Round. There is after all no consensus on how to interpret development objectives in terms of trade negotiations. For one thing, trade deals involve a reciprocal exchange of benefits; but development does not—who is on the other side of the deal? And while it might not come as a surprise that developing countries want to change the system—they did not, after all, get what was promised in the Uruguay Round—what does this mean for the direction of change? Insofar as the discussion about making the trade system more development-friendly is ultimately about implementation of Uruguay Round commitments and/or introduction of Special and Differential measures, it is not necessarily about liberalization—and in the view of some not even pro-development. In the latter view, the contribution of trade to development boils down to the traditional agenda (merchandise trade, especially agriculture and textiles) and developing countries reducing their own price distortions through reciprocal liberalization (if only as far as to adopt flat tariffs, following the Chilean model). The Doha Round has unfortunately shifted the developing country focus away from their own liberalization, some thought. These considerations raise an obvious conundrum when it comes to measuring "success" in the Round on this score.

The question of direction of change in the system

In contrast to the singular clarity of purpose of the GATT-era rounds (at least those that preceded the Uruguay Round), the context today prompts some to ask: "Where are we are taking the trade system? What is the purpose of the Doha Round?"

While some would counter by wondering, given that the die is cast, whether these musings really matter, the implicit warning of the Uruguay Round's "unintended consequences" is that it is important to have some degree of clarity of purpose. While the Uruguay Round started out similarly to other rounds, motivated in part by rising protectionism, it ended up very differently. In part, this reflected a powerful push from particular sectoral interests (most notably pharmaceuticals) to deal with intellectual property and services. However, introducing these elements into the trade rules implied systemic transformation, the understanding and implications of which, it was argued, was lacking (in part, because of the weak state of economic analysis and poor data on services and insufficiently advanced thinking about the relationship of trade to intellectual property). But, as well, a new institution was formed with no executive, a very weak legislative arm and a powerful judicial branch, in fact the strongest in the international domain—and lacking even a forum in which it could discuss systemic issues (apropos which, the emergence of the informal mini-Ministerials appears to be compensating in some fashion for the lapsing of the Consultative Group of 18, which had previously served as such a ginger group). Nor was it understood how the new institution would work in the context of a much larger active membership; no preparation was made in terms of thinking through the governance issues.

Over the course of the discussion, a number of observations were made that bear on the question of direction.

First, it was noted that, while most of the issues in the Doha Round are old and basically well-understood (if hard to resolve politically), the really new thing about this round is the active participation of a large number of developing countries—by contrast, developing country participation in the Uruguay Round was largely passive. While some developing countries are playing constructive roles (e.g., China, which has tabled a interesting variation on the tariff-cutting formulae being discussed in the context of non-agricultural market access), others have tabled proposals that include systemically impossible ideas such as providing flexibility to impose tariffs above bound levels, calling their understanding of the system into question (and suggesting in the view of some that they are rather more in need of a Marshall Plan than a trade negotiation!) In a consensus system, this becomes important because to be recalcitrant is to be important and to be wooed. In other words, the incentives as presently constituted are not helpful. While this might not affect the long-run outcome, it certainly complicates and tends to extend negotiations.[6]

The question of direction and objectives cannot be divorced from the question of negotiation modalities: it was pointed out that similar problems faced in the Tokyo Round were resolved in that context by negotiating concessions from the systemically important developing countries while effectively letting the others off the hook. The move in the Uruguay Round to the single undertaking approach, with every issue being interlinked, complicates matters here considerably. Perhaps, it was suggested, the rules of the Round need to be re-thought—e.g., a return to codes?

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[6] Editors' note: By contrast, the early GATT rounds were characterized by a "club" atmosphere in which peer pressure and like-mindedness worked against such a dynamic causing delay and complicating consensus formation.

And perhaps most broadly, the question of direction cannot be addressed without consideration of two traditional causes of institutional failure—over-expansion and over-reach.

First, as pressure to address the social dimension of globalization builds (driven by concerns over inequality of income and access to basic public services such as clean water), there is a tendency to look for effective international institutions—thus, Doctors without Borders worked very hard and succeeded in putting public health issues on the WTO agenda. The consequence, it was suggested, is that the WTO is becoming the "World Everything-but-Trade Organization" or perhaps the "World Bargaining Organization".

Second, given the evident reluctance of the WTO as an institution to say "no", it runs the risk of taking on too much and breaking the system—in particular, some feel that too much is being loaded on the dispute settlement mechanism, a theme to which we will return below.

Third, as the system expands and begins to look more like the United Nations, it was suggested that WTO rounds might lose their edge with serious trade liberalization shifting to regional negotiations. In time, it was suggested, the WTO might become like the UN—and as relevant in US eyes! The issue of WTO governance reform is thus perhaps more urgent than many think.

It was even suggested that perhaps the idea of rounds is obsolete and, noting the Finance Ministers approach, the question was raised whether or not a shift to a Ministerial framework might be advisable? It was observed in this connection that a broad set of objectives is embedded in the WTO committee structure; these committees could be charged with working on liberalization initiatives that could be periodically brought together as a "roundup". However, others argued that the Finance Ministers model would not work in the trade context: that would, for example, confront national legislatures with new rules every 6 months! Others observed that there is no objective of completely free trade built into the WTO, raising the question: do Ministers actually need to meet regularly? And some saw continuing negotiation as furnishing a ready-made excuse to avoid making decisions.

The level of ambition

The aims of the Doha Round were thought by a number of observers to be actually quite modest, including (a) completing the Uruguay Round's unfinished business; (b) refining the rules in light of seven years experience (which makes it much easier technically than the Uruguay Round where the rules had to be developed) in areas such as TRIPs, DSU, services etc.; and (c) deepening liberalization as was foreseen when the Uruguay Round concluded by negotiating the cuts that were postponed then. The greater technical simplicity does not, however, make liberalization in this round any easier politically.

The level of ambition in this round must be considered in the context of what is left to do, after eight multilateral rounds and considerable regional deepening through preferential trade agreements. To mix metaphors, "cherry picking" in previous rounds has left the hardest nuts to crack to the last. The Doha Round will accordingly, in the opinion of some of those present, be harder to move forward than its predecessors.

The EU and US have little to give and what they do have to give is very sensitive and hard to move on. While negotiators may understand that positions must change, whether that is appreciated by the political class is not clear to observers. This difficulty was in a sense inescapable: the agreement on agriculture reached in the Uruguay Round was made possible precisely because the difficult phase of making significant cuts to agricultural protection was deferred to be taken up in the built-in agenda (which called for negotiations to begin in 2000).

On the key agricultural negotiation, some argued that the opening positions of the main parties are so far apart that there does not at present appear to be the basis for an agreement on modalities. On both sides of the Atlantic, the key farm lobbies are presently quite content—US farmers with the current farm bill and the EU farm constituency with its support programs—

and will not want to see change. Whence is the political support to come to change policies that have long resisted change?

Further, the US approach of pushing the envelope in bilateral/regional agreements tends to weaken the level of ambition at the multilateral level by creating constituencies in favour of preserving existing preferences. This contrasts with the dynamic in launching the Doha Round when the US got the Africans to counter resistance from India.

In past rounds, bringing in new issues facilitated the construction of a package that worked for all. But it is not clear that this can this be done again. Is there enough to put on the table? It was suggested that, in the context of a big deal, the US could possibly do something on anti-dumping. However, the issues put forward by the EU that broaden the agenda (e.g., the Singapore issues, environment) do not evidently mobilize a constituency in Europe that could generate the pressures to move on agriculture. For example, it was suggested, there is no one obviously beating the drum for competition policy outside the Brussels bureaucracy. Insofar as there is a constituency for other EU issues (e.g., environment) its members tend to be against, not for, the rest of the trade package!

The Negotiating Agenda

The discussion addressed some of the issues being addressed in the individual negotiating groups. We take these up in turn. As a general preliminary observation, it was argued that progress of the individual negotiating groups will be determined in part by the strength, engagement and ambition of their Chairs, especially in the groups where the gaps are wide and the issues to be resolved in identifying acceptable trade-offs are complex.

Organization of the Agriculture Negotiations

Negotiations are based on the structure adopted in the Uruguay Round, which called for cuts to tariffs, domestic support and export subsidies as well as the volume of subsidized exports; with developed countries facing larger percentage cuts in all areas.

Timelines and Progress

- Negotiations have been very active, with 121 member proposals tabled.
- The modalities "first draft" on agricultural tariff reductions was circulated February 17th, 2003. It calls for reduction, by simple average, of tariffs on agricultural products, subject to a minimum reduction per tariff line. Actual amounts in square brackets are yet to be agreed.
- Developing countries will have extended time periods to implement tariff cuts, be able to declare specific agricultural products (total number as yet undecided) "strategic products" with respect to food security, rural development and/or livelihood security concerns.
- March 31st, 2003 deadline for establishing reduction commitments in export competition, market access and domestic support.

EU & US Formulae	Average Tariff Reduction	Minimum Cut per Tariff Line
European Formula		
Developed Countries	36%	15%
Developing Countries	24%	N/A
United States Formula		
Both Developed & Developing Countries	New Tariff =	$\frac{\text{Old Tariff} \times 25}{\text{New Tariff} + 25}$

Harbinson Draft—February 17th, 2003 Cuts to *Ad Valorem* Tariffs	Simple Average Reduction Rate	Minimum cut per tariff line
Developed Countries -- [5] years		
Tariffs greater than [90%]	[60%]	[45%]
Tariffs between [15%] and [90%]	[50%]	[35%]
Tariffs less than [15%]	[40%]	[25%]
Developing Countries -- [10] years		
Tariffs greater than [120%]	[40%]	[30%]
Tariffs between [20%] and [120%]	[33%]	[23%]
Tariffs less than [20%]	[27%]	[17%]
All designated "strategic products"	[10%]	[5%]

Note: *non-ad valorem* tariff cuts to be based on tariff equivalents calculated in transparent manner, using representative average [1999-2001]

Source: World Trade Organization

There was little argument with the idea that agriculture will be either the linchpin or the sticking point of the Doha Round. It is the area of trade in goods that is least liberalized, most subsidized (including remaining export subsidies), and most price distorted. It is central to the development agenda, but it is also the front of greatest political resistance to change in the rich countries, for a plethora of complex rationales (not to mention in some poor agriculture dependent countries). What can be said about the prospects for an ambitious outcome in the Doha Round, now more than three years after the launch of this aspect of negotiations?

First, it was observed that there is something of an "analytic disconnect" in the emphasis being placed on agriculture in the Doha Round since the quantitative studies tend not to show significant global welfare gains from liberalizing agricultural trade.

Second, it was argued that, insofar as a major part of the agricultural trade negotiating agenda (subsidies) is about rent transfers, it is not about trade creation *per se*. From an income distribution perspective, the major beneficiaries of liberalization would thus be consumers in the EU and Japan who are actually paying for the subsidies through high retail food prices. At the same time, while some developing countries have significant export interests (Brazil for example), many other developing countries benefit from subsidized imports as this improves their terms of trade and of course their consumers. Cutting these subsidies thus works to reduce real incomes of the poor countries. There is some similarity here to the situation in textiles where some developing countries benefit from liberalization and others from continuation of the Agreement on Textiles and Clothing (ATC).

Third, it was argued that agricultural exports have not served as the path to prosperity for any country historically—it has always been manufactured goods. Accordingly, it was questioned why agricultural trade is at the heart of a round focused on development objectives.

A number of comments highlighted some of the complexities in this area.

It was observed that the lack of historical examples of countries exporting their way to prosperity on an agricultural base may partly be explained by the fact that most countries function on a near-autarky model for food supply. Implicitly, liberalization of agriculture might enable this route as a springboard to development. The example of Chile showed that developing countries can benefit from agricultural market access if it is made available.

Also, it was observed that there have to be some winners in the US and in the EU to create the political constituency that makes it possible to cut a deal. Therefore, rent transfers among rich country rent seekers are as much a part of the issue as anything. There is, however, an acknowledged communications challenge in the developed countries to highlight these issues.

In any case, as was pointed out, we are stuck with the formulation that "Doha = Agriculture". And since one might note parenthetically that "Doha = Development", there is an implicit equation being drawn between development and agriculture. Given that, it is important to understand the structure of agricultural trade interests in the developing countries. It was suggested that, for the 60-80 countries that have export interests, the interesting areas are commodities such as fresh fruits, cut flowers etc. These are tariff, not subsidy, issues; attention shifts accordingly to the approaches being taken to tariff cutting insofar as they affect agricultural trade.

When we drill down more deeply into the specific agricultural sectors, the situation varies. One starts to break down the blocs and to get away from "big" advocacy issues. In the view of some, more analytic work is required on the impact of liberalization in sectors such as sugar and cotton where developing countries are large net exporters and face protectionist lobbies in the developed countries. There was considerable interest indicated in work of this nature underway within the World Bank. But others were of the view that the sectoral analysis on agricultural trade has largely been done; the problem is now, according to this view, the politics of dealing with entrenched protection—in other words, it is the political economy of market access that remains the key issue.

A source of concern for observers is the divide between the negotiating parties, which was described as "huge". The formula for agricultural tariff cuts put forward by the Chair of the negotiating group, Stuart Harbinson, would cut bound rates but would not necessarily result in systematic cuts to applied rates. Meanwhile subsidies would be cut. This, it was argued, would not work for developing countries: their export interests would not be advanced and they would pay higher prices for imports. By contrast, the US approach (using the Swiss formula and different coefficients) would cut applied rates. Analysis suggests that the gains from the tariff cuts under this approach would dominate the welfare loss from subsidy reduction.

The overall Harbinson agriculture proposal is, in the view of some, big enough to gain actual momentum but there is a question of "How do you get there from here?" Some see it as well ahead of its time—perhaps by 3-4 years since the negotiating timetable will be driven by the expiry of US TPA in mid-2007. By the same token, the implied timetable for agricultural negotiations is creating uncertainty for the rest of the negotiating agenda since forward movement, if not settlement on other issues depends in some cases on what the agricultural outcome contains.

There are several areas where additional research could assist in terms of providing the intellectual basis for movement from entrenched positions.

One such area, it was suggested, would be to gain a better understanding of the cost of protection in individual EU member states to facilitate the management of coalitions within Europe. Movement on agriculture within the EU also depends on an appreciation by EU leaders of the extent of flexibility that they have vis-à-vis small farmers. In France, for example, the reality is that farms are increasingly dominated by large efficient agribusiness firms and the farm population is shrinking. Consequently, measures that are designed to serve the small farmer end up disproportionately helping agribusiness. The political economy of France is thus changing. The "Massif Central" has historically played a key role in French Presidential elections; but this is now changing, meaning that the pull of French lobbies will be different.[7]

Some argued that it is also important to understand how the structure of trade preferences, including those afforded by the Generalized System of Preferences (GSP) and regional trade agreements, affects the positions of commodity exporters. Some developing countries are lining up with the EU and Japan, reflecting their trade orientation. It would be useful to know what are the options for smaller, single commodity exporters and how existing preference schemes affect them. There are some interesting developments in understanding the role of GSP in influencing trade.[8] Study of this issue could shed light on how to deliver the Doha Development Agenda given that strengthening market access in the developed world without reciprocal concessions being offered seems to be the strategy of many developing countries in the Round.

Finally, there is a specific research issue concerning the structure of protection afforded by *non ad valorem* tariffs on agricultural products. The US is pushing to have such tariffs converted into *ad valorem* equivalents, but the data are poor.

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[7] Editors' note: The Massif Central is a region in south central France in which the traditional agricultural sector is now in decline and facing out-migration of the farm population, despite government programs to attract new young migrants into the agricultural sector. President Jacques Chirac, who had previously represented the mainly agricultural constituency of Correze in the Massif Central in the National Assembly, is a member of the PRP, a French party with a heavy reliance on the agricultural vote.

[8] A study by Andrew Rose found that the GSP scheme extended from Northern (developed countries) to developing countries is associated with a more than doubling of bilateral trade (approximately 136 percent) while GATT/WTO membership failed to positive correlation with trade gains. Another recent study, however, concluded that "corrected for endogeneity and robust to numerous alternative measures of trade policy, developing countries may be best served by full integration into the reciprocity-based world trade regime rather than continued GSP-style special preferences." See Çaglar Özden and Eric Reinhardt, "The Perversity of Preferences: GSP and Developing Country Trade Policies, 1976-2000", *The World Bank Group*, January 13th, 2003. http://econ.worldbank.org/files/23188_wps2955.pdf

Non-agricultural Market Access (NAMA)

Organization of the NAMA Negotiations

Negotiations are focused on establishing a formula to achieve an acceptable level of tariff cuts, targeting: high tariffs; tariff peaks (tariffs over 15 percent, usually on "sensitive" products); and tariff escalations, which impose higher import duties on semi-processed products than on raw materials.

Timelines and Progress

- Deadline for proposals on modalities was November 2002. 14 proposals tabled, with the US, China, Japan, Korea, and the EU proposing formulas (the EU's has parameters not well defined and it is not shown below)
- Draft modalities paper tabled by the WTO Secretariat in February 2003.
- Deadline on reaching an agreement on modalities is 31 May 2003.

US proposal: Elimination of all tariffs equal to, or below, 5 percent, and modified "Swiss formula" cuts to all other tariffs. The coefficient value of 8 implies a maximum tariff of 8 percent after tariff cuts are applied to any tariff profile. There would be a subsequent move to zero tariffs by 2015.

$$t_1 = \frac{8 \times t_0}{8 + t_0}$$

where t_0 is the value of the initial tariff and t_1 is the value of the new tariff.

China's proposal: similar to the "Swiss formula"; yields higher absolute cuts to higher initial rates but larger percentage cuts to lower initial tariffs.

$$t_1 = \frac{\left(t_a + (B \times P)\right) \times t_0}{\left(t_a + P^2\right) + t_0}$$

where, t_a is the simple average of the base rates (A in TN/MA/20);
P is a peak factor defined as the ratio of the tariff to the average rate (t_0/t_a);
B adjusts for year of implementation. B=1 for 2015 or B=3 for 2010.

Japan's proposal: Members reduce their trade-weighted tariff average to a target level. Korea's formula, which differs slightly from Japan's, seeks similar reductions.

$$t_{1a}^{w} = \frac{A \times t_{0a}^{w}}{A + t_{0a}^{w}} + \alpha$$

where t_{0a}^{w} is the weighted tariff average prior to the application of the formula and t_{1a}^{w} is the weighted average after the application of the formula.

A varies with t_{0a}^{w} between 10 and 40 (i.e., is higher for higher initial tariffs)
The term α has been proposed as a constant equal to 0.3.

Several issues in non-agricultural market access (NAMA) negotiations were discussed at the workshop.

As regards formulae for tariff cuts, a number of interesting proposals have been put forward. While it remains unclear how easily agreement will be reached on a specific formula, it was suggested that the approach of having larger cuts for higher rates would probably survive.

The US has floated the most ambitious idea, suggesting an eventual move to zero tariffs on all products, although this appears not to be gathering a sufficiently broad constituency. It was noted that analysis of the US proposal in terms of bilateral reciprocity implications shows that it does not work well in a political economy sense. It was also suggested that there might be scope and utility to do this type of analysis more generally.

One interesting and promising development is that the more advanced developing countries are actively engaged; China in particular has tabled a formula for ambitious tariff cutting that is attracting serious attention. However, it was observed that the newness of China's delegation to the WTO means that they are still learning how to "sell" their formula, in contrast to the more experienced members who are out door-to-door lobbying to build support for their favoured formula.

The WTO has done some modeling with respect to the implications of various formulae. The results suggest that the gains for developing countries would be largely accounted for by a handful of sectors: fish and fish products, leather goods and footwear, textiles and transportation equipment. The WTO has placed considerable amounts of information on the structure of tariffs and the direction of trade on its website, the strategy being to facilitate the determination by countries as to where their trade interests lie.

The fifty or so least developed countries were described as generally resisting movement on tariffs—partly for revenue reasons—but as willing to consider bindings at higher rates than currently applied. This would at least provide some basis for movement—which could be significant; for example, it was noted that Kenya presently has bound only 3 percent of its tariff lines.

Textiles are an important part of the picture. Developing countries will not accept a ratcheting up of the level of ambition in the NAMA aspect of the Round if there is any backsliding on implementation of the Uruguay Round commitment to phase out the ATC. At the same time, while the US and EU have put textiles on the table, there are conflicting interests on textiles amongst the developing countries given that the phase-out of the ATC is not uniformly positive for them—China is generally understood as likely to benefit the most.

One area where there appears to be a lack of clarity concerns the process of dealing with certain non-tariff issues such as environment. For example, environmental goods were described as being in somewhat of a limbo: is the Committee on Trade and the Environment (CTE) or the NAMA negotiating group to negotiate liberalization in this area?

With regard to the question of the potential impact on trade flows of liberalization in the NAMA area, it was observed that the structure of duties collected provides insight as the extent to which tariffs remain important.

Worldwide, duties collected amount currently to about US$190 billion indicating that there is considerable scope to get some results from tariff cutting. That being said, tariff collections are much smaller for many countries than their stated tariff rates would imply given their level of imports. In Jordan, for example, the duty rate is 70 percent while tariff collections average about 15 percent of imports. Meanwhile, in China, duties collected were about 1 percent of trade at a time when the applied tariff was about 12 percent. It was questioned whether these kinds of gaps might reflect weak administration or perhaps corruption? In China's case, duty remittance for special export processing zones (SEZs) would be a factor that might explain this gap. If one takes into account that actual imports might even be larger than stated in many countries, the extent of *de facto* tariff collection is strikingly small.

Several other interesting observations emerge from duty collection data:

- south to north payments are four times greater than north to north payments;

- south-to-south payments are the largest, accounting for 42 percent of the world total; and
- 71 percent of the developing country tariff payments go to other developing countries.
- The effective duty rate paid by small developing countries is often far higher than that paid by industrial countries.[9]

Finally, as regards the revenue implications of tariff reductions, it was noted that only a handful of countries have a tariff share of public revenue which exceeds 15 percent, suggesting this is not a major constraint on progress on liberalization. It was pointed out that there are recent IMF studies on how to deal with a revenue drop-off following liberalization which have recently formally been transmitted to the WTO for consideration by its Members.

Services

The services discussions, it was generally thought, are progressing reasonably well, with a significant number of countries having made services requests, across all four modes and covering a wide array of issue areas. There is a hope that perhaps as many as fifteen countries will table offers by the deadline of end-May. Some developing countries are linking their services participation to other areas (notably Brazil) but others are not.

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[9] As examples, duties paid by Mongolia and Bangladesh on exports to the US were cited as implying effective duty rates of 16 percent and 14 percent respectively; by comparison, developed countries which paid comparable amounts of duty (e.g., Norway and France respectively) did so on far larger volumes of exports, thus attracting far lower effective rates of duty, on the order of 1 percent or less. These observations are supported by analysis set out in Edward Gresser, "America's Hidden Tax on the Poor: The Case for Reforming U.S. Tariff Policy", *Policy Report*, Progressive Policy Institute, Washington D.C., March 2002.

Organization of the Services Negotiation

GATS addresses trade in services under 4 modes of supply:

- Mode 1: Cross-border supply. A service provided in one country to a customer in second country, without either party required to travel.
- Mode 2: Consumption abroad. A service provided by a domestic provider to a customer who travels from a second country.
- Mode 3: Commercial presence. A service provided by a majority-owned (or otherwise foreign controlled affiliate) to individuals in a second country.
- Mode 4: Presence of natural persons. A temporary visit by a service provider to a second country to provide a service.

Timelines

- Pursuant to a mandate in the Uruguay Round, negotiations to liberalize trade in services under the General Agreement on Trade and Services (GATS) began in 2000 and were subsequently folded into the Doha Round.
- The Services Council established the negotiating guidelines and procedures in March of 2001.
- Initial bilateral market access requests were to be tabled by June 30th, 2002 (although members have continued to submit proposals past this deadline). Virtually all members have received initial requests from 30 mainly developed and larger developing countries.
- Members are to respond to requests with initial offers by 31 March 2003.
- The Special Session of the Council for Trade in Services established, on 6 March 2003, agreed criteria for granting credit for autonomous liberalization (the purpose of which is to facilitate bilateral bargaining for specific commitments on market access).

The services negotiations are raising a large number of technical and not-so-technical issues, but there is no talk of changed architecture, notwithstanding the many criticisms that have been leveled concerning the GATS structure.

- Overall, the services trade discussions are plagued by a lack of high quality and sufficiently detailed data. There were no useful data in the Uruguay Round when the architecture for the GATS was developed and the situation has not improved materially since. Investment statistics, especially those relating to services, are also poor, which poses issues for analysis of Mode 3 (commercial presence).

- The evaluation of barriers to services entry requires a qualitative approach, which poses analytical challenge since the existing economic models require quantification (and, it was noted, the models yield quantitative results that vary by such a wide range as to undermine any confidence in their projected outcomes).
- On safeguards, there is a difficult issue, related to the data gap, of a country proving that it has a problem in order to trigger a safeguard action (although some questioned why safeguards are required in services in the first place).
- Subsidies pose big issues—the biggest being how to define a trade-distorting subsidy; it was ventured that services sector subsidies will prove too hard to deal with.
- Regulatory frameworks also raise tricky issues: how, for example, does one define "necessity" in respect of a regulation?

There now is talk that the reference paper approach used for the telecommunications sector might be adopted to facilitate negotiations in other sectors; specifically, this has been mooted for the energy and postal services. Whether this approach will gain momentum is, however, still an open question. An issue which affects the reference paper approach—and is one of the biggest issues in services more generally—is the question of classification: what is the scope of a particular service sector? A related technical issue is whether a reference paper would necessarily have binding status as is the case with the telecommunications paper—a panel recently struck on a Mexico-US dispute is in fact based on the binding nature of the telecommunications reference paper.[10]

The technical difficulties in this negotiating area are sector-specific and complex, which is generating a lot of demand for trade-related technical assistance (TRTA) for capacity building. Indeed, the largest number of requests for TRTA has been related to services—not only for negotiations but also for the associated domestic regulatory analysis. It was noted that developing countries are taking an interest in services, sending quite a few experts from capitals to the negotiations, and looking for technical help. For example, Mauritius was cited as an example of a developing country that has indicated interest in exporting services and is looking for technical assistance. The Doha Declaration highlighted TRTA for developing countries, which has made TRTA part of the negotiating agenda. While a large portion of the TRTA budget is committed to services, questions of cost and resources are arising.

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[10] Editors' note: The panel on *Mexico-Measures Affecting Telecommunications Services* which was established on March 17th, 2003, will consider a challenge by the US that Mexico's implementation of its commitments are inconsistent with particular aspects of the Reference Paper.

However, it is not only the developing countries that are having a tough time getting their services offers together. It was noted that Canada is co-chairing (with India) the Mode 4 working group and promoting transparency of the overall regime affecting services trade whole (including the programs of various government departments and sub-national levels of government). This forces countries to understand their own schemes and also raises awareness of coherence of policies. Canada is finding this formal discipline hard which raises questions about the experience of other countries—especially in the developing world?

One general concern raised about TRTA in the services regulatory area is that the developed countries effectively are in effect selling their own high-overhead regulatory approaches to the developing countries; this, it was suggested, might be counter-productive in the longer run. It is not out of the question that developing countries might develop more cost-effective approaches on their own (Costa Rica was cited as an example of a country which had found innovative ways to address its regulatory reforms).

Insofar as services negotiations are engaged on regulation, it was argued that participation should be on an opt-in basis; otherwise the process becomes one of establishing a common domestic regulatory framework which the Europeans have found is a difficult thing to achieve in an effective manner as their economic union has evolved.

Given the complexities in this area, some observers conclude that the focus of the work at this stage should be expanding coverage under existing services agreements.

While developing country participation in the services negotiations is greater than many might have expected (perhaps because the negotiation mode is seen as developmert friendly—i.e., go at your own pace), it is nonetheless comparatively modest in overall scope. Some observers suggested that developing countries' reluctance to engage more energetically in the services discussions is ill-informed as they risk missing an important window of opportunity to lock in the current extent of openness in many services markets. For example, the trend to outsourcing of administrative tasks by US states is starting to draw a reaction domestically and the window of opportunity for developing countries to gain a foothold in this potentially lucrative market could well close.

Mode 4 issues were the focus of a number of comments.

It was noted that India, which had been blocking services liberalization in the discussions to launch the Uruguay Round at Punta del Este, has taken a proactive stance on services trade this time; ironically, however, security concerns are now essentially closing the Mode 4 window where it has clearly defined interests. But, while Mode 4 might be severely stinted by the reaction to 9/11, it was suggested that developed countries could allow their citizens to spend publicly funded health benefits in foreign countries (e.g., retirees who have moved to warmer climates) thus providing alternatives for developing countries to sell services.

The welfare implications of opening up Mode 4 are not entirely clear. It was noted that economic models of labour mobility tend to show huge income gains (and, controversially, also show that in the presence of restrictions on labour mobility, a tariff that induces foreign direct investment as a means to skirt the tariff barrier can be welfare enhancing). However, it was acknowledged that such models do make a very strong assumption that labour is homogenous; it was suggested that this assumption might indeed be largely responsible for the strong results.

At the same time, it was also observed that in building construction in some US cities is being done by Latin American workers who have had the energy, skills and luck to make their way there. If Mode 4 were opened up, these same workers would be recruited in their home country and shipped back at will with the rents going mainly to the entrepreneur.

More generally, Mode 4 discussions link to the hot button issue of labour migration. As one observer put it, removing limits on immigration raises the question of what constitutes a nation? In the view of some, it is hard to think of a more explosive issue for the EU than Mode 4—it was noted that even the EU inter-community services market was not completed. At the same time, it was observed that there is a market for international labour mobility. Canada, for example, is seeking skilled immigrants and importing migrant workers for agriculture on a seasonal basis. It was suggested that demographics would, in due course, make the EU a demander on Mode 4 as well.

The services negotiations are also serving as a lightning rod for anti-globalists, with the GATS becoming the target of a worldwide movement (which, it was noted is creating difficulties for some countries in terms of how to respond—the pithy description of their reaction being "a deer caught in the headlights"). Specific sectors where sensitive nerves are being touched include retail services, where liberalization will affect the "mom and pop" retail outlets and involve hard adjustment costs, and municipal water supply where a campaign is building based principally on moral issues such as access by the poor to clean water.

A problem in the area of private sector municipal water provision is that there are very few companies commercially engaged in delivering such services. The result is that any attempt to privatize involves a multinational and, worse still from a local public relations perspective, a foreign multinational. In these circumstances, any attempt by investors to raise rates to pay for improved facilities draws a severe reaction as higher rates shut people out of water supply. For example, it has been argued that privatization in Latin America has undermined access by the poor to basic services like water. The role of the IMF and World Bank in pushing privatization of public services is also drawing a reaction. It was noted that licensing is an alternative to privatization to enable trade in services and raises different issues: e.g., who controls the rate? Who regulates and how?

In terms of analytical issues, it was noted that, in modeling services, researchers have taken an approach similar to goods in dealing with producer services. However, there is a trickier issue in dealing with services of an "intermediation" nature. Since consumer welfare derives from the product not from the intermediation services associated with acquiring the product, growth of these services does not clearly raise welfare—for example, expanding margins expands measured services trade but reduces consumer welfare.

Finally, it was noted that e-commerce is neither quite on the table, nor quite off the table. It is being dealt with in separate "dedicated sessions" which are examining horizontal linkages. Some of the issues that have been raised include cultural indicators in digitized content.

Dispute Settlement

Organization of the Negotiations on Dispute Settlement

Negotiations are based on work started in 1997 and proposals subsequently submitted. Negotiations on modifications are targeted for completion no later than May 2003. The Doha Declaration clearly stipulates that the DSU negotiations are not to be part of the single undertaking.

Negotiation topics are primarily technical procedural matters: 3rd party rights, issues related to the submission of *amicus curiae* briefs, countermeasures, and systemic issues on how the panel and Appellate Body processes are to work.

An overarching issue is created by the desire to improve transparency and legitimacy in the eyes of both internal and external observers, but how this is to be accomplished is not so clear.

The dispute settlement system has worked reasonably well but the experience of its first seven years of operation has revealed flaws. There are many good proposals on the table to improve the system but agreement, it was suggested, is unlikely to be reached by the target of end-May 2003, even with a good Chair's paper. For example, the sequencing discussion has failed to come to a resolution and there is now a proposal to collapse the Article 21.5 and 22.6 panel processes.[11] Accordingly, it was suggested that Ministers might wish to consider extending the negotiations.

The more difficult issues are the larger questions surrounding dispute settlement. For example, it was argued that retaliation does not work effectively because it hits innocent bystanders, potentially reduces trade, and raises angst within the business community about market access. The EU has proposed fines as an alternative; as was observed at the workshop, this would in turn introduce a fundamental change at the heart of the system, not to mention all sorts of minor and perhaps not so minor issues. Questions for example were raised about collection, who would pay and to whom. For example, if the proceeds from a fine were funneled by national governments to industry, incentives to raise complaints would be significantly increased (and, in this connection, it was also suggested that, in the case of a developing country that is receiving World Bank/IMF support, payment of fines might simply represent flow-through of development assistance from the international financial institutions).

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[11] Editors' note: The "sequencing" issue under the Dispute Settlement Understanding boils down to whether the authority to suspend concessions under Article 22.6 should be first subject to a compliance-panel ruling under Article 21.5. There was an effort to reform the DSU before Seattle, which failed as a result of EU-US disagreement. Proposals to amend Articles 21 and 22 of the DSU have been submitted by several Members and were discussed at the General Council on October 10th, 2000 and on December 7th-8th, 2000, but with little progress made. In the *EU-Bananas* case, the Appellate Body agreed that the terms of Articles 21.5 and 22 were not a 'model of clarity', and referred the matter to WTO membership to provide clarification or decide what the proper sequence should be. Subsequently, the EU has noted that in "light of the practice followed consistently since then"—including in subsequent disputes such as *US - Foreign Sales Corporation* where the US insisted that a 21.5 panel review its efforts to comply with the WTO ruling before right to retaliate was granted under a 22.6 panel—"it would appear that Members now broadly agree that completing the procedures established under Article 21.5 of the DSU is a prerequisite for invoking the provisions of Article 22, in case of disagreement among the parties about implementation. The problem is therefore clearly less acute than in the past." That being said, the EU stated that they remain in favour of clarifying the DSU.

Mexico, meanwhile, has controversially proposed retroactive damages in order to promote early settlement.[12] However, it was argued that, as rules get more complex, there is the increasing likelihood that countries will be found offside on measures that they had reasonable grounds to believe were legitimate; in this context, retroactive damages could put a chill on entering into obligations.

That being said, support was voiced for placing greater emphasis on early settlement because empirically it appears to be more effective than litigation in eliciting commercial concessions. Analysis of the outcomes of WTO-era versus GATT-era disputes shows that the WTO has improved matters in terms of increasing the likelihood of getting commercial concessions to plaintiffs but the gains are largely in the early settlement phase. Developing countries do not do as well as developed at this phase and the initiatives designed to move cases more quickly to the litigation phase thus run counter to their interests, including their own proposal to have litigation costs funded by the developed countries. In this connection, it was also noted that the EU-US dyad has actually seen a worsening in outcomes as issues move from the diplomatic stage of consultations to the litigation stage—concessions are negatively signed and statistically significant to a panel outcome, even those in favour of the complainant.

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[12] Editors' note: Mexico has argued that length of the WTO process (cases can take up to three years) gives domestic interests a *de facto* waiver during this time and has proposed four changes: (a) early determination by the panel of the level of nullification or impairment; (b) retroactive determination and application, (c) preventive measures to address cases where damages would be difficult to repair, and (d) "negotiable remedies", which amounts to the right to trade the right to retaliate to other WTO members who might be in a better position to implement them without damaging themselves. Mexico proposed three alternatives for starting the clock on damages: (a) date of imposition of the disputed measure; (b) date of request for consultations; and (c) date of the establishment of the Panel. See Mexico's submission to the Negotiating Group on Improvements and Clarifications of the Dispute Settlement Understanding (TN/DS/W/23).

Some argued that the big challenge to the system was not to tighten up the legal procedures but to cut back the system before it breaks. The deepest issues here relate to legitimacy. The norms of democratic legitimacy developed for the nation state cause the international institutions to face inevitable challenges.

These problems are exacerbated when these institutions over-reach as, it was argued, each has tended to do. The IMF, World Bank and the WTO all suffer from this reaction. In the case of the WTO, the Financial Sales Corporation case, which addressed features of the US tax system, was cited as an example that had generated considerable anti-WTO sentiment within the United States. Such cases, it was suggested, are not contributing to the future viability of the system.

Others countered that it becomes very convenient for national governments to lay blame at the foot of the system rather than to acknowledge that they themselves set out the tasks for these institutions! In any event, sovereignty issues are not raised since a country can decline to implement panel recommendations and choose to maintain measures found not to be in conformance with its obligations; the consequence is simply a symmetric reduction in the obligations of other contracting parties to it.

From an historical perspective, it was noted that the basic tension between legal rigor and political/diplomatic flexibility goes back to the debate that took place when the DSU was being developed in the Uruguay Round. The ironic thing is that it was the EU that wanted diplomacy and non-transparency while the US, backed by Canada, wanted to make the system more legal and transparent. Now the US position has shifted and it is now proposing to make the DSU less automatic and to restore some political flexibility to the mechanism.

In this connection, one suggestion for a way to introduce greater flexibility into the system was to consider redefining negative consensus in a way that could realistically be achieved—for example, some level of super majority.

Another idea advanced was that perhaps the DSB could refuse to take on particular cases or it could decline to render a verdict. Since the international public law structure is supposed to be complete with the implication that every question can be answered, scope for incompleteness could be written into the law.

The idea of the DSB using its "good offices" to mediate disputes outside the ambit of the WTO was questioned in view of these considerations.

Attention was also drawn to an institutional issue emerging in the WTO, namely Secretariat staff undertaking much of the work in drafting panel reports. This situation is resulting, it was argued, in some eighteen-to-twenty Secretariat staff and the seven-member Appellate Body in effect driving the system!

It was also argued that poorly prepared national submissions can hamstring the Secretariat in driving to a sound decision as Secretariat officials have to deal with the material at hand, the objective being mediation, not generating case law that establishes a body of jurisprudence. Yet, cases are inevitably establishing precedents. This is a real issue.

With the proliferation of regional trade arrangements, the issue of forum shopping[13] for dispute settlement begins to pose issues for the multilateral framework (e.g., the possibility was noted that a case taken to both the NAFTA and WTO systems might be ruled on differently).

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[13] In passing, it was noted that a Brazil-Argentina dispute went to the WTO rather than to the Mercosur system; disputes involving Canada, the US and Mexico are finding their way to the WTO as well.

Organization of the TRIPs Negotiations

The Doha Round is to review the entire TRIPs Agreement, as required under Article 71.1. Article 27.3(b), which deals with patentability or non-patentability of plant and animal inventions, and the protection of plant varieties, is singled out for specific review. The key negotiating issues, however, are public health and geographical indicators.

Public Health

The separate declaration on TRIPs and public health stated that governments should not be prevented from acting to protect public health, and reaffirmed the right to use the flexibility provided for in the TRIPs Agreement, including by clarifying the use of measures such as compulsory licensing and parallel importing. The declaration also extended the deadline for least developed countries to apply provisions on pharmaceutical patents until January 2016.

The main bone of contention is the scope of the public health carve-out in the TRIPs agreement. The US has asked that the proposed carve-out cover only 23 infectious diseases (e.g., HIV/AIDS, malaria, tuberculosis and other similar infections that risk epidemics) and only apply to developing countries to avoid a fundamental undermining of patent rights for a broad array of pharmaceutical products. Developing countries argue that the mandate of the Doha Declaration referred to "measures to protect public health" in general and are resisting a specific list approach. The US has since followed up by stating that it would not challenge any member "that breaks WTO rules to export drugs produced under compulsory license to a country in need".

Geographical Indicators (GI)

The Doha Declaration set a deadline for completing work on a multilateral system that registers geographical indicators (names used to identify products with particular characteristics that come from a specific place). A registration system for wines and spirits has already been started. Negotiations also are addressing the issue of extending "the higher level of protection" to other products beyond wine and spirits. Whether the TRIPs Council even has a mandate to examine this issue is being debated.

The TRIPs and public health issue is proving extremely difficult to resolve. Some were of the view that bringing protection of intellectual property rights (IPR) inside the trade tent has made this issue harder to resolve, not easier. For example, it was suggested that, if HIV/AIDS were dealt with as a health issue, the main lobby interests (such as the pharmaceuticals) could perhaps be induced to write a cheque to help address it. But, serving as a basis for an attack on the general level of IPR, the situation is working to *stiffen* resistance, which is not helping the people who require treatment.

But others argue that there *is* a trade dimension to IPR from which trade policy cannot walk away. This puts a heavy premium on revising the TRIPs agreement—expanding the list beyond AIDS/malaria and addressing parallel imports—in a way that does not undermine international protection for IPR more generally. Some combination of the WTO/WHO is needed, it argued, to resolve the issues in this key domain.

As for the issue surrounding geographical indicators (GIs), it was suggested that this needs to be understood in historical context. GIs were developed to help small farms to establish the quality credentials of products such as wines, where the region was known but the individual small wineries were not. In the last decade or so, there has been a shift towards corporate brands, due in no small part to the emergence of Australian and Chilean commercial wineries on the scene. The situation is also now changing in Europe. However, the "old" farmers still support the old system and this situation will only change as generational transition progresses and the lobby structure changes.

Meanwhile there are problems about how wide the GI net could be cast. And this brings out one of the "dark" aspects of regional trade agreements: Chile signed onto EU views on GIs through its preferential agreement with the EU.

Organization of the Negotiations

The Doha Declaration remitted the Singapore issues to working groups, with the go-ahead to be based on a "decision to be taken, by explicit consensus, at that session on modalities", namely the 5th Ministerial Meeting in Cancun.

Trade and Investment

Some 39 Member submissions (and another 9 by the Secretariat) have been tabled. Seven areas have been identified for further clarification: scope and definition of the Agreement; ttransparency; non-discrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; consultation and the settlement of disputes between members.

Trade and Competition

Areas are to be clarified: (a) core principles including; transparency, procedural fairness, non-discrimination and "hardcore" cartels (i.e., those not formally set up); (b) voluntary cooperation on competition policy among members; and (c) capacity building for developing countries

Transparency in Government Procurement

Separate from the plurilateral Government Procurement Agreement, the declaration states that negotiations shall be limited to the transparency aspects and therefore will not restrict the scope for countries to give preferences to domestic supplies and suppliers." Development concerns, technical assistance and capacity building are all to be discussed.

Trade Facilitation

The Doha Declaration recognizes the need for "expediting the movement, release and clearance of goods, including goods in transit, and the need for enhanced technical assistance and capacity building in this area".

The Singapore issue cluster was touched on only lightly during the discussions with little enthusiasm voiced for addressing these issues in the Doha Round.

One of the issues did, however receive some attention. It was pointed out that, in a post-9/11 security environment, the continuing emphasis on security (which is an added cost to trade) appears to be weighing down on trade (more stringent border controls, screening of containers etc.). Trade facilitation could assume greater importance as a means of preventing a further deepening of home bias in this context.

As noted earlier, it was not obvious that bringing some or all of the Singapore issues into the negotiations would serve to improve the trade-offs. Moreover, the basic premise of having the same rules apply regardless of the level of development was thought to raise some difficulties in this cluster of issues.

Other Issues

Several issues that are part of the Doha Development Agenda were not directly addressed during the workshop:
WTO rules—Anti-Dumping and Subsidies: The negotiations are to clarify and improve existing measures while preserving the basic concepts and principles of these agreements. Initially, members are to indicate where clarification and improvements are required in the two agreements, before starting the second phase of negotiations. The subsidies in fisheries have already been specifically singled out as an important sector where gains can be made for developing countries.

Start: January 2002
Stock taking: 5th Ministerial Conference, 2003 (in Mexico)
Deadline: January 1st, 2005, part of single undertaking

WTO rules—Regional Trade Agreements (RTAs): The Doha Declaration mandates the clarification and improvement of "disciplines and procedures under the existing WTO provisions applying to regional trade agreements." As background, it might be noted that, to date, the Committee on Regional Trade Agreements has not completed an assessment of *any* preferential trade agreement notified to the WTO and ruled as to whether it conformed to the provisions of the WTO agreements (in particular to Article XXIV which addresses the conformity of RTAs with WTO rules). The reason for this state of events is that the interpretation of the specific wording of Article XXIV conditions has proven controversial.

Start: January 2002
Stock taking: 5th Ministerial Conference, 2003 (in Mexico)
Deadline: January 1st, 2005, part of single undertaking.

Trade and the Environment: The Trade and Environment Committee (CTE) was asked to pursue all ten items on its current work program, but to pay particular attention to:

- How environmental measures effect market access, especially for developing countries;
- Incorporation of environment and development into trade policy to generate "win-win-win" situations: i.e., where eliminating or reducing trade restrictions benefits environmental and developmental outcomes;
- Intellectual property; and
- Environmental labeling requirements.

The single highest profile trade and environment issue is the consistency of WTO rules with multilateral environmental agreements (MEAs). Approximately 20 out of the 200 extant environmental agreements have trade specific provisions. Although there have been, thus far, no challenges to trade measures taken in conformity with an environmental agreement, negotiations are to examine and clarify the relationship between existing WTO rules and specific trade measures set out in relevant MEAs.

Negotiations are also to reduce or eliminate tariff and non-tariff barriers on environmental goods and services. As well, similarly to the Subsidies negotiations, negotiations are to clarify the link between fisheries subsidies and the environmental impact on fish stocks.

- Committee Reports to Ministers: 5th Ministerial Conference, 2003 (in Mexico)
- Stock taking: 5th Ministerial Conference, 2003 (in Mexico)
- Negotiations deadline: January 1st, 2005, part of single undertaking.

Summary Comments

The Doha Round is unfolding at what might turn out to be an epochal and pivotal time in the global economic and political order.

The system of global governance that we have today, and in which the system of multilateral trade rules is embedded, emerged from the conditions and problems of the 1940s. The institutions created then have adapted to changing conditions and problems but the structure nonetheless reflects a past time.

Issues have changed. For example, the issue of global redistribution is implied by the huge disparities in incomes. But how is this to be done? Meanwhile, as global economic weight shifts, the G7 is seen as increasingly less well suited to provide cohesive economic leadership. And some see the possibility of a major backlash against multilateral institutions as part of the diplomatic fallout from the Iraq crisis. One way or the other changes may be afoot.

In view of the troubled macroeconomic situation in the global economy, with risk of a period of slow and bumpy growth, the first priority might well be simply to preserve the system.

Could Canada make a difference? Those outside Canada think so. But it would take a bold move that Canadians would gulp to hear: One suggestion was that Canada going to free trade would make a difference.

From the perspective of the Chair, the sense of the room could best be summarized as ambivalent but, on balance, somewhat optimistic, especially as, in the medium term, trade would again be seen as an essential element to restore economic growth and international trust and confidence. Some conveyed a sense of urgency to address instabilities in the system and to make course corrections before the WTO sails into rougher waters than it can handle. Others were more sanguine. They saw the world trading system as being strong overall, reflecting its evolution on the basis of cautious pragmatism, as one comment put it. With the influx of developing countries, there are new problems but also opportunities. But the basic counsel is that we do not need to rush the Round; the intellectual basis for a big result is not there yet and there is time to think things through.

As it is, the current situation is perhaps best summarized by a comment made by one observer: It is a curious experiment that we are undertaking in the Doha Round: seeking an ambitious outcome without the customary leadership and apparently without clear vision!

The Importance of Being Multilateral (especially in a regionalizing world)

John M. Curtis[*]

Introduction

The world of trade policy is rarely tranquil. Nowadays, it is hectic, if not turbulent, with the clarity of vision of the past fifty years less apparent. The Doha Round of multilateral negotiations, launched under the trying circumstances post 9/11, is in motion but facing severe headwinds from a flurry of protectionist actions, most importantly by the purported champion of more open markets, the United States—although this is not to ignore the recent European Union decision to extend the essence of the Common Agricultural Policy for much of the decade—and growing pessimism about the outcome of the upcoming WTO Ministerial in Cancun, Mexico.

Meanwhile, there is a flurry of activity on the regional and bilateral fronts—ninety-four (94) Article XXIV arrangements have been notified to the WTO since its creation on January 1st, 1995 and many more are in the offing.[1] A further twenty (20) regional integration agreements in respect of services have been signed under GATS Article V, while the WTO enabling clause has allowed a further six (6) regional agreements (including a free trade agreement between India and Sri Lanka) to get underway.[2] No corner of the world is without some regional or bilateral trade dynamic as various countries seek to be their own hubs rather than someone else's spokes—implicitly therefore securing their place at the expense of others in what seems to be an increasingly uncertain global trading environment.

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[1] Source: WTO website, accessed December 23rd, 2002: http://www.wto.org/english/tratop_e/region_e/provision_300602_e.xls.

There is a minefield of issues to walk through in providing an objective assessment of the role of preferential regional and bilateral trade agreements—which I will refer to generally as RTAs—in global trade policy. Preferences are, in trade law and in economic policy terms, essentially synonymous with discrimination; RTAs thus raise one of the oldest of "trade and…" issues, namely trade and discrimination.[3] They bring with them, along with the scope to create additional trade and explore new trade rules, the possibility of trade diversion, distortion of relative prices, and proliferation of rules. These effects can be especially severe when external tariffs are high, as they often still are in developing countries. In the end, the result can be what *The Economist* recently described as "a befuddlingly complex series of overlapping deals, each with its own pattern of preferences, schedules and exclusions."[4]

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[2] *Ibid.*

[3] The early critical work on RTAs is associated with Jacob Viner, *The Customs Union Issue* (New York, Carnegie Endowment for International Peace, 1950). Interest in this issue was revived by the Single European Market initiative launched in 1986, the contemporaneous negotiation of the Canada-US FTA and the chatter in East Asia about a bloc that eventually prompted the formation of the Asia Pacific Economic Cooperation forum (APEC) in 1989. For a review of the discussion of the late 1980s/early 1990s from a multilateralist perspective see Jagdish Bhagwati, "Regionalism versus Multilateralism", *The World Economy* 15(5), 1992: 535-555. For a recent overview, see James Mathis, *Regional Trade Agreements in the WTO, General Agreement on Tariffs and Trade: Article XIV and the Internal Trade Requirement*, (The Hague: TMC Asser Press, January 2002)

[4] See, "Coming Unstuck", *The Economist*, November 2nd, 2002, pg 14.

It is argued here that regionalism can be a positive force, but only in the right circumstances, namely in the context of a strong multilateral system where the margin of preference that regional pacts can confer is small. To paraphrase Oscar Wilde, I will argue "The Importance of Being Multilateral", even (and perhaps especially) in a rapidly regionalizing world.

The Game that is Afoot: Competitive Regionalism

While many of us like to think that the global trading system is working well overall, *The Economist* charges that, today, "global trade takes place on a playing-field as level as the Himalayas, with the added spur to trade and investment of not knowing what the contours will be from one month to the next." The concerns that inform this charge are spurred largely by the current flurry of activity in formation or discussion of regional and bilateral preferential trading arrangements.

There is little question that the game today in international trade is regionalism.

The standard bearer for regionalism has long been the European Union. Over the years, the European economy has received a series of boosts from deepening and widening the customs union that has been evolving since 1968[5]. This dynamic will continue: the EU has recently signalled a strong commitment in the form of recent acceptance, by 2004, of ten new members (Poland, Czech Republic, Hungary, Slovakia, Slovenia, Malta, Cyprus, Latvia, Lithuania and Estonia) to their regional club. This development will expand the EU's common market significantly. Further expansion is more or less committed (Bulgaria and Romania) and/or to be discussed (Turkey). Regional integration within Europe is complemented by the extensive web of bilateral/plurilateral agreements that the EU has struck with eastern European and non-European partners; this web is now so extensive that only a handful of significant trading countries (Canada included) trade with the EU on the basis of the Most Favoured Nation clause—perversely, this has morphed into what now could more accurately be labelled "Least Favoured Nation" status.

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[5] On July 1st, 1968, the European Customs union enters into force. Remaining customs duties in intra-Community trade are abolished 18 months ahead of the Rome Treaty schedule and the Common Customs Tariff is introduced to replace national customs duties in trade with the rest of the world. http://europa.eu.int/abc/history/1968/1968_en.htm

The Americas are also awash in regional/bilateral activity.

The most comprehensive current initiative is the Free Trade Area of the Americas (FTAA) process. The momentum of this process has clearly been weakened by the financial crises that have swept South America since contagion from the Asian Crisis hit Brazil in 1998, and arguably by the widening of the US external deficit which *inter alia* reduces the ability of the US to provide the market opening required to underwrite the deal—indeed, the United States must be looking at the FTAA as a market opportunity to help resolve its own external deficit problems.[6] On the one hand, popular support in South America for the "globalization" strategies of the 1990s has waned with the collapse of benefits from those strategies. Argentina has had what has been termed the worst peacetime economic collapse in the history of industrialization. While it has not turned its back on trade, questions are being asked about how Argentina, never mind the international economic community, managed its engagement in the global economy. Brazil, meanwhile, faces a great challenge in walking a tightrope between asphyxiating domestic growth through austerity measures and generating sufficiently large primary surpluses to keep its public debt from exploding in the face of extremely high real interest rates. The fate of other South American countries hangs very much in the balance as South America's linchpin economy struggles to restore the positive dynamic of the 1990s, which for the five years since the spillover effects from Asia's crisis has proven elusive.[7] Nonetheless, the FTAA Ministerial in Ecuador in November 2002 was able to keep the process more or less on track with a tentative signing date announced for end-2004.[8]

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[6] There is an interesting parallel between the FTAA and European integration in that the motive for the FTAA is in part political, as underscored by the essence of the bargain: democratization for market opening. At the same time, the political consensus for the process lacks the power behind Europe's process—the lessons of Europe's wars over the past 500 years and partially into the last century made the main European protagonists, France and Germany, willing to underwrite the formation of the Union. There is no equivalent intensity of purpose in the United States.

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[7] While the FTAA would ideally represent a solution to the bouts of instability that Latin America has suffered in the past few decades, there are good grounds to believe that it alone cannot solve a more fundamental issue of trade-finance coherence implicit in the economic geography of the Americas. In financial terms, the Latin American countries are firmly in the orbit of the US dollar. In trade terms, however, they have highly differing orientations, reflecting the geographic and cultural factors that explain trade intensities in gravity models. Latin American countries' trade is oriented in roughly equal measures towards North America, Europe and to other Latin American partners. Mexico is oriented primarily toward the United States, with a much smaller trade link to Europe and only marginal ties with other Latin American countries. Brazil is the opposite, with much stronger trade links to Europe and relatively small and equal links to the United States and other Latin American partners. Argentina is oriented mainly to Europe and other Latin American partners. Chile and Peru, which have growing trans-Pacific links, are the most diversified in terms of their trade patterns. The diversity of trade orientation in the region poses problems in the context of (a) large swings in real exchange rates of the key international currencies (dollar, yen and euro); (b) the revealed proclivity of second-tier currencies to evidence behaviour consistent with multiple equilibria and to negotiate the move between such equilibria (which are often quite distant from one another) with sufficient rapidity to place great adjustment strains on the real economy; and (c) lengthy sustained divergences of currencies from points of equilibrium such as defined by purchasing power parity. There is every potential for exchange rate developments to generate instability in the region with the system of trade acting as the conduit. This is precisely what happened in the late 1990s when, as a result of Brazil's forced devaluation and the euro's post-introduction slide against the US dollar, Argentina's exports to its two main trading partners, Brazil and Europe, faced the equivalent of steep tariff increases while its import-competing industries faced the equivalent of large own-tariff cuts (or alternatively large export subsidies). Given sufficient time, the competitive disadvantage undermined Argentina's economic position and paved the way for its subsequent economic disaster. Since geographic and cultural realities make it unlikely that the FTAA will fundamentally alter the trade orientation of South America, the FTAA offers no solution to this fundamental coherence problem. Nor, incidentally, is dollarization any more of a solution; indeed, it works in the wrong direction since it only intensifies the coherence problems in the event of future exchange rate shifts. For a fuller discussion see Dan Ciuriak, "Trade and Exchange Rate Regime Coherence: Implications for Integration in the Americas", *The Estey Centre Journal of International Law and Trade Policy*, 3(2), 2002: 256-274.

In North America, the post-9/11 emphasis in the US on the "homeland" has paradoxically both thrown a spanner in the works of regionalism and stimulated discussion of the need to deepen the current NAFTA arrangements. In the trade/ economic context, the immediate priority has become the border measures implemented as part of upgraded security measures. However, as "secure trade" threatens to replace "free trade",[9] concern about assuring access to the US market has given a new sense of urgency to the ongoing policy debate about NAFTA. Mexico is on record as wanting economic union by 2020. In Canada, there is no policy consensus but considerable discussion concerning the source of the puzzling counter-theoretical combination of massive expansion of bilateral trade yet diverging productivity and real wage trends in the context of a sharp relative improvement in macroeconomic fundamentals but persistence of an exchange value for the Canadian dollar well below its purchasing power parity. Some analysts see the preferred response as lying in deepening the free trade arrangements with the US[10], or moving to a common currency through some arrangement.[11] The 10-year anniversary of the signing of the NAFTA in 2003 will provide fresh impetus to the debate about the benefits of the agreement and its predecessor, the Canada-US FTA. In terms of the nuts and bolts of the agreement, the highest profile issue has been whether to reopen Chapter 11 in respect of investor-state disputes.

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[8] Ministerial Declaration of Quito. Seventh Meeting of Ministers of Trade of the Hemisphere, November 1st, 2002. http://www.ftaa-alca.org/ministerials/quito/minist_e.asp. It nonetheless remains at least somewhat unclear how the FTAA would work in conjunction with the other regional RTAs, which differ amongst themselves in terms of depth and breadth—NAFTA, Caricom, Mercosur and the Andean Pact in particular. This patchwork quilt of RTAs is being further complicated by the flurry of bilaterals/regionals under discussion or active negotiation involving FTAA members.

[9] This is the subject of a study by Carolyn Lloyd, "Is Secure Trade Replacing Free Trade?", in this volume. The interesting thing that is emerging in this research is that secure trade might well turn out to mean, perhaps counter-intuitively, free-er trade, in the sense that the smart border initiative, which is based on risk management that allows low risk trucks to speed by while higher risk vehicles are subject to greater scrutiny, may actually be more efficient than the border arrangements which it replaced. This just might be shaping up to be a win-win positive story.

Meanwhile all three NAFTA partners are independently active bilaterally over and above engagement in the FTAA talks. Mexico has long been pursuing bilateral deals (FTAs with the EU, Chile, Israel and negotiations with Singapore), as has Canada (FTAs with Chile, Israel, and active negotiation with the Central American Four and Singapore, together with some analytical exploration of possible deals with Europe and Japan). The US has become newly energized on this front (FTAs with Israel, Jordan and expanded preferences for Africa and the Caribbean and imminent deals with Chile and Singapore).[12]

In East Asia, there is a new-found interest in regional arrangements that stands in contrast with the region's history of weak interest in RTAs.[13] The heightened interest in RTAs is partly as a result of the Asian Crisis, which demonstrated that markets considered East Asia a region, even if the members themselves were reluctant to formalize any corresponding relations. This reinvigorated the notion of an East Asian Economic Group that excludes Australasia (Australia and New Zealand had different dynamics during the crisis, more closely aligned with the Americas than with Asia; this latter development has meanwhile suggested the viability of a link between NAFTA and the Australian-New Zealand Closer Economic Relations pact).

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[10] See Wendy Dobson, "Shaping the Future of the North American Economic Space, A Framework for Action" Commentary No. 162, April 2002. http://www.cdhowe.org/english/whats_new/whats_new.html

[11] See Thomas Courchene and Richard Harris, "From Fixing to Monetary Union: Options for North American Currency", prepared for the CD Howe Institute, June 22, 1999. http://www.sfu.ca/~rharris/howe99.pdf

[12] US Trade Representative Robert Zoellick is reportedly under presidential orders to "litter the world with trade agreements". See: "U.S. trade envoy pushes for series of bilateral deals", *The Wall Street Journal*, October 25th, 2002, B9.

[13] The discussion here follows Dan Ciuriak, "Is the European Exchange Rate Mechanism a Model for East Asia?", paper delivered at the 44th Annual Conference of the American Association for Chinese Studies, hosted by The University of Southern California, Los Angeles, October 26th-27th, 2002; and forthcoming in *Asian Affairs: An American Review (Spring 2003)*.

In seeking to create a regional economic framework for East Asia, the member economies face the issue of the region's many fault lines, including in geopolitical terms (especially the differing relations of the USA to Japan and China), regional politics (the lingering historical mistrust of Japan and the plethora of regime types), culturally (especially important in Southeast Asia in the post-9/11 context) and economically (as evidenced by the mercantilist rivalries between China and Japan in particular). There is no counterbalancing regional institution with any power to bring a regional voice to the issue. This raises the question of who is to lead?

Until recently, there would have been no question that Japan would be in the best position to lead. The situation has changed, however, with the rise of China and Japan's decade-long economic malaise. The result appears to be a renewed competition between the two, rather than the formation of a partnership. Thus, while both China and Japan have traditionally eschewed regional arrangements, both are now vying to conclude such agreements.

Japan has been talking about new trade arrangements to, *inter alia*, Singapore (with which an agreement was recently concluded[14]), Korea, Australia, and New Zealand, and advocating still greater integration in the region.[15]

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[14] The Japan-Singapore Economic Partnership Agreement (JSEPA) was signed in January 2002. See: Ramkishen S. Rajan and Rahul Sen, "The Japan-Singapore "New Age" Economic Partnership Agreement, May 2002, www.economics.adelaide.edu.au/rrajan/pubs/JSEPA_brief.pdf

[15] See, for example, "A Sincere and Open Partnership", speech by the Prime Minister of Japan, Junichiro Koizumi, Singapore, January 14th, 2002, proposing the establishment of an economic community linking North Asia, ASEAN and Australia/New Zealand

Meanwhile, China, on the heels of acceding to the WTO in 2001, has recently signed a FTA agreement with the governments of ASEAN to be implemented in 2010. The *Financial Times* expressed the view of many when it wrote; "the deal reflects China's desire to strengthen its sphere of influence in its own backyard".[16] Notably, China was prepared to underwrite the regional economic integration agreement as the proposal by Prime Minister Zhu promised an "early harvest" for Southeast Asian trading partners.

The motives of the others in the region are less clear.

For ASEAN, the move seems to be evidence that its members acknowledge the extent to which its regional organization has been weakened by the Asian Crisis in the first instance and by the cultural fault lines within the region that have been put in stark relief by the geopolitical turn of events since 9/11, not least the Bali bombing.[17] Notably, ASEAN's secretary-general said that the region had little choice but to strengthen economic ties with its huge neighbour. "You can either close yourself off from China and crouch in fear or engage more closely. Although some industries will get hurt, the overall impact on both China and ASEAN would be beneficial."[18] Given this lie of the land, the emerging regional dynamic in East Asia would seem to be less problematic the stronger the multilateral dynamic.[19]

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[16] See "ASEAN leaders and China sign for free trade area", *Financial Times*, November 5th 2002, pg 6.

[17] These recent developments have only added to the problems that ASEAN has had in generating dynamism. The problems that weighed on the grouping prior to these events include the fact that it was to some extent adrift as its Cold War origins no longer gave it obvious direction; and its expansion to include several countries (including Myanmar, Vietnam, Cambodia and Laos) which significantly lagged the development of the original five members militated against rapid deepening of the pact (not to mention introducing significant new issues raised by the differences in governance regimes of the new entrants). Singapore's various bilateral initiatives in recent years have been widely interpreted as indicative of its assessment that ASEAN's prospects as an economic vehicle have dimmed.

[18] See "ASEAN leaders and China sign for free trade area", *Financial Times*, Pg 6, November 5th 2002

Finally, in Africa, the New Economic Partnership for African Development (NEPAD) appears to have energized the renewal of interest in trade liberalization (and hopefully rationalization)[20] on a continent that has perhaps the world's most complex trade environment due to the number of regional, extra-regional and multilateral RTAs and preferences applying to its trade flows, many of which date from the colonial era.

The Perennial RTA Issue: Building Blocks or Stumbling Blocks?

In theory, the arguments about RTAs break down into those of a pure economic nature and those of a political economy nature.

The Economic Argument: Regionalism and Trade Creation

The pure economic arguments are that regional agreements stimulate greater export orientation, in part by raising the consciousness of business to look beyond a domestic market and in part by reducing the risks of undertaking the investments (which are of a sunk cost nature) needed to establish a foreign market presence—advertising, establishment of distribution and service support systems abroad, etc.[21] The question then becomes whether RTAs generate net global welfare gains which in turn depend on whether or not the economic growth engendered by the efficiency gains that flow from that increased trade dominate any trade distortion and associated inefficiencies in the allocation of resources that arise from the preferential tariff structure and the dead-weight costs of administering the arrangement—for example, the costs of monitoring rules of origin to enforce the RTA.[22]

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[19] Further to the discussion in footnote 7, it is worth observing that the same trade-finance coherence issues that complicate the picture for the FTAA also loom large in East Asia. The region's currency alignments are principally towards the US dollar. However, while China's RMB has depreciated in nominal terms over the past two decades (and in real terms over the past few years), Japan's yen has appreciated steeply over the same period. With the RMB still fixed to the dollar, it is poised to depreciate if and when the US dollar does what many analysts expect, which is to depreciate as part of the correction of the US external deficit. Such a further depreciation would simply further exacerbate the already existing trade tensions between China and Japan. For the other regional currencies, insofar as they are direct competitors of Japan (e.g., Korea) or are dependent upon Japan for financing (Southeast Asia) but continue to be oriented toward the United States in terms of trade, swings in the dollar-yen parity in real terms will continue to pose difficulties that will be felt through the system of trade, the more so the more tightly knit the trade grouping.

[20] The NEPAD Market Access Initiative sets out as one of its aims to promote and improve regional trade agreements. At the present, it appears to be at the "vision" stage. See http://www.avmedia.at/nepad/indexgb.html

The evidence suggests that, while trade diversion has probably occurred as a result of RTAs, trade creation on balance has dominated leading to welfare gains.[23] This is certainly the logical conclusion from the empirical results from gravity models that membership in an RTA boosts trade substantially.

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[21] See Caroline Freund, "Different Paths to Free Trade: The Gains from Regionalism," *The Quarterly Journal of Economics*, Vol. CXV, No. 4, November 2000.

[22] The administrative costs for governments and the private sector in establishing the origin of products increases the greater are the incentives for importers and exporters to circumvent the rules by repackaging imported goods for onward export. In low-income countries, the incentives can easily lead to corruption, raising the administrative requirements of policing the system for all concerned. This is an unseen cost of trade that rises as RTAs proliferate. Avoidance of these costs is one of the major incentives for countries that trade heavily with each other to create a customs union.

[23] The strength of RTA trade creation is not entirely undisputed. Insofar as trade deals or monetary arrangements are prompted because countries trade intensively for other reasons, the empirical evidence could overstate the potential to expand trade: the flow of causation might well be from trade to these policy initiatives rather than vice versa, as we might suppose.

Some key quantified "stylized facts" concerning trade-inhibiting factors that have been identified in the gravity model literature are as follows:[24]

1. *Borders*: two firms located on opposite sides of a national border trade two thirds less than if they were located in the same country.
2. *Distance and Contiguity*: if two countries are not adjacent, trade falls by half, with a further 1 percent decline in trade for each 1 percent increase in distance between them.
3. *Currencies*: use of different currencies (even if fixed exchange rates are used) reduces trade by two thirds, with a further 13 percent reduction due to exchange rate variability.
4. *Culture*: if two countries speak different languages, trade falls by half.
5. *Trade Rules*: if two countries do not belong to a free trade area, trade falls by two thirds—and even further if tariff and non-tariff barriers are at the heights typical of developing countries.

Even ignoring the effects of distance, tariffs, and other factors such as being landlocked versus having access to a coast and/or shared colonial history, if two countries are not immediate neighbours, have different currencies, speak different languages and are *not* parties to an FTA—in other words the typical situation facing most pairs of nations—the chance of an international transaction taking place is less than one percent of that of a domestic transaction. An FTA increases this propensity to about 2½%.[25] This indicates a powerful trade-generating effect. Table 1 summarizes these effects.

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[24] These assessments are taken from Jeffrey A. Frankel, "Assessing the Efficiency Gain from Further Liberalization," paper delivered at the conference *Efficiency, Equity and Legitimacy: The Multilateral Trading System at the Millennium*, Harvard University (June 1-2, 2000). This paper is available online at http://www.ksg.harvard.edu/cbg/trade/frankel.htm.

[25] The implied "border effect" for Canada-US merchandise trade from these stylized values is 10.6. This accords well with John Helliwell's estimate of about 12 post-FTA. See John F. Helliwell, *How Much do National Borders Matter?* (Washington: Brookings Institution, 1998); pg 115.

Table 1. Stylized "Gravity" Effects on Trade Propensity

Trade-inhibiting Factor	Percentage reduction of intensity of cross-border trade compared to domestic trade
Presence of Border	33 %
Not adjacent	50 %
Separate currency	33 %
Exchange rate volatility	87 %
Different language	50 %
No FTA	33 %
Gravity effect, excl. distance and tariffs	0.8 %
Gravity effect with FTA	2.4 %

This is not to discount entirely the costs of trade diversion; there is some evidence of reasonably significant trade diversion, particularly in the case of agreements where there are high external tariff to third parties. For example, Mercosur is thought to have had comparatively significant trade diversion effects. The European Union's agricultural policy has clearly had diversionary effects.[26] With regard to NAFTA, the low average tariffs to third parties suggests general trade diversion has been minimal; that being said, issues have been raised in connection with rules of origin.[27] Moreover, the relatively high textiles tariff that the US applies to developing countries but not to NAFTA partners provides an example of the concern raised about buying into partner countries' patterns of protection.[28] All of that being said, the very powerful trade-creating result for regional agreements in the gravity model literature is an important argument for regional agreements.

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[26] For example, Canadian and U.S. (Washington State) Macintosh apples have been replaced in the U.K. by higher-priced, (and, to some tastes, lower-quality) Granny Smith apples from France.

[27] For example, auto sector rules of origin (ROOs) have been a bone of contention for Japan over the years. Even as the role of tariffs in defining regional blocs has diminished, the role of ROOs has increased. In this regard, an adverse consequence of multinationals shifting production from their home bases in industrialized countries to developing countries is that they have tended to promote special access to their home markets for countries in which they invest. This leads to an insidious use of ROOs, as in the United States' recent Africa Bill, to favour sourcing of intermediate products from the multinationals' home market. How significant is this latter trend? Probably quite large; producers in Mexico and the Caribbean Basin reached a watershed in 1997, when they accounted for a larger volume of U.S. apparel imports than those in the Far East. And for every dollar worth of textile and apparel products imported from countries in the Western Hemisphere in 1999, the United States exported to them 58 cents worth of prod-

The strong trade creation result for RTAs also plays into the question of whether to devote resources to regional vs. multilateral liberalization. And, on the face of the evidence so far considered, the logic for putting the resources into regional pacts is persuasive. This position is buttressed by the following set of considerations:

First, the Article XXIV free trade agreements notified to the WTO—in particular those in Europe, North America and Australasia—cover a large amount of the trade between countries whose internal trade flows account for 43 percent of the

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ucts in this sector (including fabric, partial made-ups, and finished goods). By contrast, the United States exported just 4 cents worth of product to Asia for every dollar worth of textiles and apparel imported from that region. The Africa-Caribbean Bill enacted in May 2000 extended these preferences to Africa. Meanwhile, other arrangements (such as the "outward-processing program" that applies to US imports from Macedonia and Romania) exempt countries from quota limitations if they meet US ROO requirements. For discussion, see Craig VanGrasstek, Vernon's Product-Cycle Paradigm and the Political Economy of Trade: A Comment on Alan Deardorff's "Market Access for Developing Countries", available at www.ksg.harvard.edu/cbg/Conferences/trade/Comment.pdf. This in turn tends to create classes of developing countries. These arrangements inject a not inconsiderable amount of noise into the international price system.

[28] The observation that countries participating in RTAs buy into not only to each other's markets, but also into the trade protection that their partners have against the rest of the world, is not given, in my view, sufficient attention. The implied distortions can be especially costly for small countries entering in RTAs with large countries, since the structural adjustments that they make in buying into their regional partner's trade protection regime place them at risk of further structural adjustment if and when these trade protections are reduced through subsequent multilateral liberalization. The most serious aspect of this may be that new investment is prompted in existing protection schemes—which in turn may tend to harden those protections in the face of multilateral pressures.

global total (see Table 2). In addition, a considerable further amount of trade is covered by arrangements such as MERCOSUR, ASEAN and others that do not meet the criteria for Article XXIV.

Table 2. Trade Flows covered by Article XXIV Agreements, 2001

Agreement	Internal Trade Flows, 2001 (US$)	Percent of Global Total
European Union (EU)	1,296,617	20.4%
North American Free Trade Agreement (NAFTA)	619,786	9.7%
European Free Trade Area (EFTA)	190,934	3.0%
EFTA bilaterals with others	194,200	3.1%
Central European Free Trade Agreement (CEFTA)	16,149	0.3%
Australia-New Zealand Closer Economic Relations (CER)	5,377	0.1%
All others	407,138	6.4%
Total within Article XXIV Agreements	2,730,201	42.9%
Global Total	6,365,100	100.0%

Source: Direction of Trade Statistics, Yearbook 2002. Article XXIV Agreements and Membership therein obtained from the WTO website http://www.wto.org/english/tratop_e/region_e/provision_300602_e.xls, accessed December 23rd, 2002. Data shown are total merchandise imports of the participants to the RTA from other members of the RTA. Since the Article XXIV agreements do not require 100% coverage of merchandise trade flows, the share of total trade that is subject to actual free trade conditions is somewhat less than the share of total trade between parties to such agreements.

Second, the ongoing multilateral negotiations are being held in the shadow of the eight previous rounds that have reduced average tariffs in the industrialized countries to about four percent (when Uruguay Round commitments are fully implemented).[29] There is simply less protection to work on: based on a survey of recent empirical work, the average estimate of the overall potential gain in economic welfare from full multilateral liberalization was a surprisingly small 2.5 percent of global income.[30] Within this average, there was a high degree of variation in the specific estimates for gains from liberalization of trade in agriculture, services and manufactures.[31] Obviously only a fraction of that would be derived from the extent of liberalization that could reasonably be forecast for the Doha Round; even such gains would be realized only gradually over a period of years following negotiation and implementation.

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[29] See, for example, Sam Laird, "Multilateral Approaches to Market Access Negotiations", Staff Working paper TPRD-98-02, World Trade Organization, http://www.wto.org/english/res_e/reser_e/ptpr9802.doc, pg 4.

Thus, even to the extent that multilateral liberalization has efficacy in promoting trade growth, these considerations argue for modest expectations concerning further gains from this source. However, our ability to claim that multilateral liberalization promotes trade growth to any extent has recently been challenged by an unsettling result obtained by Andrew Rose in attempting to identify the increased trade that could be attributed to WTO membership.[32] Using a conventional gravity model, Rose found that for 98 countries that joined the GATT/WTO between 1950 and 1998, membership in the WTO had overall no statistically significant impact on the intensity of trade between two pairs of countries. As Rose comments, the findings run counter to common sense and thus constitute as much an invitation to future work as a challenge to conventional wisdom.

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[30] See John M. Curtis and Dan Ciuriak, "The Nuanced Case for the Doha Round", in John M. Curtis and Dan Ciuriak (Eds.), *Trade Policy Research 2002* (Ottawa: Department of Foreign Affairs and International Trade, 2002), pg 90-91.

[31] If we exclude the high and low estimates for each sector, the average gain was only 1.4%. In level terms, the gains from full liberalization amount to US$790 billion (in respect of the 2.5 percent figure) and US$450 billion (in respect of the 1.4 percent figure) scaled up to the estimated size of the global economy in 2002.

[32] See "Andrew K. Rose, "Do We Really Know That the WTO Increases Trade?", Working Paper 9273, National Bureau of Economic Research, October 2002, http://www.nber.org/papers/w9273.

There are two key facts brought out in Rose's study that enable the incorporation of Rose's overall results into a theory of the role of the GATT/WTO that is consistent with (a) the common sense understanding that the GATT/WTO was an important contributing factor to the vast expansion of trade and investment in the post-WWII era; (b) the general view that there remains important unfinished business for the multilateral trade system to address in the context of the Doha Round; and (c) that there is indeed an underlying tension between multilateralism and regionalism.

1. Examining the impacts by decade, Rose reports evidence of positive and significant effects of GATT membership in the 1950s. The estimated gains shrink in the 1960s when GATT membership expanded and the General System of Preferences (GSP), which does have a significant positive impact on trade intensities, was integrated into the GATT framework in the context of the Kennedy Round. By the 1970s, the impacts turn negative, they were small but positive in the 1980s and unstable in the 1990s.[33]
2. Rose also reports a significant impact of GATT/WTO membership for industrial countries, especially the originally contracting parties, which constituted the wealthier, most highly industrialized countries in the world.

Provisionally, I am inclined to interpret these results as follows.

First, there seems to be a general pattern of what could plausibly be considered diminishing returns to openness.[34] This can be understood on the following basis: since GATT members generally extended the MFN tariff to non-members,[35] the significant industrial tariff reductions within the GATT of the 1950s and 1960s were already reflected in trade flows between GATT members and non-members by the time the 1970s came around. Countries joining the GATT since the 1970s therefore gained fewer additional benefits beyond those achieved as positive externalities to global trade from the early intra-GATT liberalization.

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[33] *Ibid.*, pg 13.

[34] John Helliwell has made this point in terms of the welfare gains from trade. See, for example: John F. Helliwell, "Globalization: Myths, Facts, and Consequences", C.D. Howe Institute Benefactors Lecture, 2000. The same point would seem to apply in terms of further reduction of tariffs that have already been reduced to little more than nuisance levels and below the level where they would enter in any significant way into trade calculations,

Second, the findings of positive GATT results for liberalization amongst the industrial countries which constituted the early entrants is broadly consistent with the fact that GATT/WTO liberalization has been ineffective in liberalizing trade in the areas of interest to developing countries who were the later entrants—agriculture and products such as textiles in which they have significant comparative and competitive advantage. The framing of the Doha Round as a "development round" explicitly designed to enhance the ability of developing countries to benefit from multilateral trade in a sense reflected implicitly what Rose's statistical work reveals.

Third, the decline in apparent trade gains from GATT accession in the 1960s coincides temporarily with the introduction during the Kennedy Round of a generalized tariff preference for developing countries into the framework of the multilateral system; this evolved into the familiar GSP.[36] Although the Kennedy Round achieved by far the largest gains in tariff reduction in the history of the GATT up to that time, the gains in trade for new entrants since then has been associated with the GSP. This finding must be read in conjunction with other work on the pattern of global trade that reveals a much more significant degree of under-trading compared to global norms between developing regions as compared to between developing and developed regions.[37] Taken together, these observations point to a fault line in the global trading system that to my knowledge has not previously been so clearly and starkly demonstrated: that is, the introduction of preferences into the system of global trade, quite separately from the Article XXIV arrangements, had an important role in shaping the pattern of trade in a hub-and-spoke fashion with the industrialized countries at the heart of the system extracting the main benefits.

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[35] Thus, China's massive expansion of trade in the 1980s and 1990s was in the context of the extension of MFN to China by the US in 1979 and by other major trading partners even earlier. China's major tariff reductions from an average of 35% to about 16% on the eve of WTO entry would also tend to cloud any statistically significant effect on China's trade from WTO entry.

[36] For a discussion of the evolution of the initial measures adopted by the GATT in 1965 into the familiar General System of Preferences, see Bernard M. Hoekman and Michel M. Kostecki, *The Political Economy of the World Trading System: From GATT to WTO* (Oxford: Oxford University Press, 1996), pg 236-238.

Fourth, it is important to bear in mind that a study based on merchandise trade flows would not identify such benefits from the later rounds (most notably the Uruguay Round) that derived mostly from the agreements dealing with investment, services, and technology transfer, or from the refinement of the rules for managing the system, most importantly the development of the dispute settlement understanding. Here it is useful to recall Sylvia Ostry's description of the dynamic that led so many developing countries to join the GATT in the Uruguay Round—not necessarily because of the immediate market access that was on the table but rather to obtain the procedural safeguards of the GATT against unilateral protectionism by developed countries.[38]

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[37] See IMF, *World Economic Outlook*, September 2002, Table 3.3: Undertrading in Developing Countries 1995-99, pg 119.

[38] As she explains, "a new Special 301 of the 1988 Trade and Competitiveness Act was targeted at developing countries with inadequate intellectual property standards and enforcement procedures. As the Uruguay Round negotiations proceeded, the message in Brasilia and New Delhi [the leaders of a group of developing countries resisting the inclusion of the "new trade policy issues" in the round] became clearer: given a choice between American sanctions or a negotiated multilateral arrangement, an agreement on TRIPS began to look better." See Sylvia Ostry, "The Uruguay Round North-South Grand Bargain: Implications for Future Negotiations," paper delivered at the conference *The Political Economy of International Trade Law*, University of Minnesota, September 2000.

While the role of the WTO clearly goes beyond the impact of negotiations on merchandise trade, it is nonetheless a powerful result that the trade-creating power of a regional free trade agreement seems to be much greater for the participants than the gains available from multilateral initiatives. The evidence considered above makes a powerful case for the large amount of energy pouring into regional trade discussions and negotiations. And, in contrast to previous decades, where the fear was that RTAs were being created as "fortresses", it appears that, given today's export-oriented growth agendas, the main motivation for reciprocal trading arrangements appears simply to create surer access to foreign markets. In this context, the end result would be in effect a race to bottom in protectionism, not a bad outcome at all. Indeed, conceptually, when members from different RTAs sign new RTAs linking the blocs, the effect achieved would be essentially the same as a multilateral agreement: in the limiting case, the end result would be global free trade. New Zealand's WTO Ambassador has also argued that this perspective would "also ease concerns about the rapidly spreading network of regional trade agreements, with their varying rules and preferences".[39]

The political-economy case for regionalism

Some of the political-economy benefits from regional trade arrangements are generally agreed to be the following:

There are faster negotiating results. The fewer the number of players, the easier it is to establish a trade agreement, as difficulties over language, details and multiplicity of positions/negotiating objectives are resolved more quickly in negotiations.

- The proof of the pudding is in the eating: given the number of regional trade arrangements (especially if we count bilaterals along with the plurilateral arrangements) that have successfully been concluded compared to the slow and intermittent push of multilateral liberalization, this claim can surely be upheld.

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[39] See, Frances Williams, "WTO urged to scrap tariffs on non-farm goods", *Financial Times*, November 5th, 2002.

"Lock and load": For developing countries especially, RTAs can help "lock in" domestic economic reforms, while at the same time serving as a "learning" experience to prepare for the multilateral stage.

- The behaviour of emerging markets during the recent round of crises suggests that RTAs appear to have indeed been effective in "locking in" gains from trade. For example, Mexico's response to its financial crisis in 1994-1995 was undoubtedly shaped by its membership in NAFTA; at the same time, membership in NAFTA added to the US interest in stabilizing Mexico's economy and thus arguably strengthened the international support package. Similarly, one can point to the fact that there was effectively no backsliding on trade in East Asia as the crisis unfolded in that region in the late 1990s, an important contributing factor to the speed of the subsequent recovery. This is a matter for interpretation, of course, but the commitments to trade through the ASEAN Free Trade Agreement and the WTO arguably played a role in shaping the regional response to the crisis. The APEC commitments to free and open trade in the Asia Pacific, while not technically an RTA, also may have helped shape the response.

RTAs serve as a testing ground: trading nations pioneer approaches to solving trade problems that then serve as the model for multilateral agreements.

- There have been many developments in regional trade arrangements that have subsequently been multilateralized, or which serve as potential models. For example, within NAFTA there have been developments of investment protection in terms of investor-state dispute settlement, arbitration in disputes between states, and in areas such as the incorporation of intellectual property protection, services and trade-related investment in trade agreements. Many of these were later instrumental in informing the development of multilateral rules.

Regional agreements can stimulate progress on multilateral agreements

- The usual case cited in this regard is a possible link between the formation of the NAFTA with the conclusion of the Uruguay Round. Under some interpretations, NAFTA was an insurance policy for the three participants against a failure in the Uruguay Round; at the same time, NAFTA is argued by some to have spurred closure in the Uruguay Round. Similarly, there was an acceleration and deepening of the ASEAN Free Trade Agreement (AFTA) in response to the APEC commitments to free and open trade in the Asia Pacific by 2010/2020; in effect, because ASEAN is embedded in APEC, its members felt that it had to liberalize faster and more deeply than APEC to remain relevant. There appears to be some evidence for this positive dynamic.

There are several other claims of a political economy nature that are sometimes made on behalf of regionalism (leading to deeper integration, creating zones of harmony and reducing latitude for beggar-thy-neighbour policies) that are essentially subjective evaluations. Deeper integration is undoubtedly possible in an RTA context, as shown by the European Union. That being said, the political underpinnings for such a development are obviously the key determining factor; there can be no presumption that an RTA will progress beyond a trade deal to become something deeper. The difficulties that the EU has in negotiations due to pre-commitments made in developing internal positions suggest that the "zones of harmony" may be established at some cost in flexibility. Similarly, there is little evidence that nations have not sought to use whatever tools are at their disposal to advance their own interests, even within trading blocs; indeed, the flurry of bilateral negotiations by members of regional groupings as well as evidence of intervention by some central banks to maintain competitive valuations of exchange rates testifies to that.

The case for multilateralism in a regionalizing world

Given the above, it appears to be a no-brainer: the way to stimulate trade is through RTAs. Why then does the question continue to hang over regional arrangements as to whether they represent building blocks or stumbling blocks? What is the case for multilateralism in a regionalizing world?

Generally speaking, the positive empirical assessment of RTAs must be qualified since there can be no certainty that RTA formation works in all contexts and will continue to supply a positive dynamic in a forward-looking sense. In particular, there are serious doubts being expressed about the ability of an RTA-driven process to deal with the truly difficult systemic issues raised by agricultural trade, developing country assistance and the functioning of the dispute settlement mechanism. This in turn raises concerns that the energy devoted by many countries to out-manoeuvring competitors through RTAs is taking the wind out of the sails of the Geneva process.[40]

RTAs probably will not be central to issues that are critical to agricultural trade

Market access for agricultural products promises to be the linchpin of a successful Doha Round outcome—or the shoals on which the WTO round founders. For the majority of the developing countries, there is no other single development in trade that carries as much potential benefit. At the same time, the divisive agricultural trade issues between the major industrialized economies, US, the EU and Japan, can scarcely be resolved otherwise than in a multilateral context.

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[40] These concerns are growing, particularly in the United States, where the ambitious agenda of bilaterals, coming on top of the FTAA process and the ongoing Geneva round threatens to spread scarce negotiating resources too thinly, despite expression of confidence that that there will be no "slacking off on the WTO at all" by USTR Robert Zoellick. See "U.S. trade envoy pushes for series of bilateral deals", *The Wall Street Journal*, October 25th, 2002, pg B9. For an expression of concern that the complications posed by RTAs will undermine the multilateral process ("It makes it that much less likely that governments will even try.") see: *Coming Unstuck*, *The Economist*, November 2nd, 2002, pg 14. With regard to the issues that are emerging in dispute settlement, see John M. Curtis, "What Lies Ahead for International Trade: Issues for 2003" presentation to the Toronto Association for Business and Economics, Toronto, September 26th, 2002; mimeo.

There are also a number of complex issues concerning agricultural trade on which broad consensus would seem to be required—implying multilateral solutions. For example, there is considerable resistance to extending the market competition/trade paradigm from manufactured goods to agriculture. Insofar as this resistance is based on all sorts of reasons that traditionally were equated with traditional protectionism, the arguments could be rejected and liberalization pursued without qualm. But machines and biological processes *are* different. New concerns will be driven by industrialization of agriculture—emerging global scare over BSE and similar diseases will raise huge issues particularly concerning trade in "inputs" (whether genetic material, feedstuff which is the issue in BSE, or genetically modified crops that might "leak" out into natural populations). These are major challenges for the global SPS regime, application of the precautionary principle, and ultimately the credibility of the WTO governance regime. These issues may or may not arise in the context of RTAs—probably not since the WTO is the most likely locus of activity given the cross-regional nature of agricultural trade.

The development aspects of the Doha Round

Insofar as there are serious concerns about trade diversion and costly distortions from regional pacts, these attach primarily to developing regions where effective border barriers are quite high. For example, while the South American countries have rather low trade intensities, the shortfall in the amount of trade compared to the expected amount from gravity models is actually quite small.[41] In the case of both intra-regional Latin

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[41] This rather surprising finding emerges from an IMF study published in the Fall 2002 *World Economic Outlook*. This study used a gravity model of trade based on the period 1995-1999. The extent of under- or over-trading

American trade (e.g., intra-MERCOSUR and Andean Pact trade) and extra-regional trade with industrial countries, actual trade of Latin American countries *exceeds* the expectations of the gravity model. The shortfall in Latin America's trade is thus more than fully accounted for by "missing" trade with developing countries outside of the hemisphere. This empirical evidence suggests that there are rich potential trade opportunities for Western Hemisphere developing countries from the multilateral negotiations in the Doha Round.

In a similar vein, African countries have a large number of RTAs both within the region and between countries on that continent and developed countries. African countries have, of course fared quite poorly in terms of overall economic performance, with little evidence of the sort of international integration that characterized developing Asia, which notably has few regional agreements. The inconsistency of the evidence for positive results from regional pacts involving developing countries led the World Bank recently to conclude that smaller developing countries might be better off liberalizing on a multilateral level.[42] Similarly, a 2002 WTO report stated that south-south regional agreements between small states, or between them and other developing countries, are unlikely to raise welfare for the bloc as a whole and, in fact, are likely to lower welfare for the smaller and less developed partner countries. The recommendation was that RTAs lower external trade barriers, whether unilaterally (where countries are in a free trade arrangement) or by lowering the common external tariff (where countries are in a customs union).[43] The effect of this would be, of course, to reduce the margin of preference conferred on the member countries. In turn, this would reduce the price distortions and trade

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reported in that study was therefore in the context of the global norms for that time period.

[42] See Maurice Schiff, "Regional Integration and Development in Small States", *The World Bank Research Group*, Policy Research Working Paper 2797, February 2002.

[43] *Ibid*, pg 23.

diversion to which the RTA would otherwise give rise—which would tend to be particularly significant in the context of developing countries which still maintain high tariffs if for no other reason than to raise taxes.

Secondly, as noted above, insofar as agricultural market access is key to integrating developing countries into the global economy, there is little chance of this happening through regional pacts alone. This is underscored by the fact that the US is highly unlikely to move on agriculture in the FTAA, where it is critical to many Latin American countries, given the fact that Europe and Japan are not involved. In other words, the multilateral process holds a very important key to progress at the regional level in this key area.

Thirdly, the major efforts of putting "trade into development" through technical assistance are also predominantly being carried out at the multilateral level. If nations spend all their powder on regional pacts, the trade-offs in various areas that are required to elicit the commitment of resources needed to mobilize sufficient technical assistant to make these efforts successful will be lacking at the multilateral level.

Systemic Issues: dispute settlement and forum shopping

To date, perhaps the most encouraging aspect of the global trading system has been the evolution of the dispute settlement system embedded in the WTO. While some are troubled by questions about national sovereignty as the dispute settlement panels and the Appellate Body delve into matters that appear to be "inside the border", the fact that the WTO's Dispute Settlement Body is functioning as a quasi global economic Supreme Court, and equally importantly, that member economies are abiding by its rulings (or accepting the sanctions that it authorizes for failure to live up to commitments) represents an important step forward from the "rule of the jungle" in international commerce.

But the system is far from perfect: it is slow, expensive and its remedies trade-reducing; it needs and deserves considerable attention and perhaps fresh thinking from the global community.

Several recent issues highlight this. In this regard, I should like first to draw attention to the recent WTO dispute settlement process over the United States Financial Sales Corporations (FSC) policy. In this case, the European Union was given the right to retaliate in the amount of several billions of dollars for a violation of export subsidy laws by the United States which, by any reasonable economic assessment, did little actual harm to commercial interests, being a broad and shallow subsidy with *de minimus* impacts on any particular industry. If the EU exercised its right to impose countermeasures against US exports, it could do so with large and narrow tariffs that significantly impact on particular industries.

This award underscores the ongoing transformation of the management of the trading system from a practical commercial exercise towards legalistic formalism. If the EU prudently decides not to exercise its right to retaliate, and the US finds a way to redesign its tax laws to bring them into formal compliance with WTO commitments, real damage will be avoided. However, the fact that the system yielded a cure which was, in economic terms, clearly worse than the disease suggests that there is now a serious imbalance between the commercial pragmatism that was the traditional hallmark of the GATT system and the legalism to which the WTO has been moving.

A rather different but equally troubling situation is unfolding in the case of the Canada-Brazil disputes over regional aircraft subsidies. Unlike the FSC case, these involve large and very narrowly targeted subsidies that have a direct impact on major sales in an industry that has become a global duopoly. Viewed in game theoretic terms, the pay-off matrix facing Canada and Brazil in this instance is such that both countries have been driven to courses of action that the WTO has found to be in violation of their multilateral commitments and which constitute a "lose-lose" outcome for both parties—the classic Prisoner's Dilemma outcome. Caught in this lose-lose situation, Canada has been granted the right to retaliate massively against Brazilian imports and Brazil requested still larger countermeasures against Canadian imports (although the award given Brazil was considerably smaller than it requested). Clearly, the injuries that both countries have already suffered in the form of subsidies paid out to foreign airlines could be compounded by mutual destruction of bilateral trade flows.

Whether the drafters of the WTO dispute settlement provisions fully or even dimly contemplated these types of complexities, the system is kicking out decisions that risk compounding the original problems.

This underscores at a minimum the limitations of the system and the need for sound political judgement in managing the trading system. Significantly, from the perspective of the issues addressed in this paper, it underscores the need for deployment of political capital by WTO members to the refinement of the system. Insofar as a major commitment of resources to the regional activity drains away necessary resources from the multilateral exercise, the cost-benefit ratio of regional activity rises in a not directly observable way.

Conclusions

The conventional wisdom is that regional and multilateral approaches to trade liberalization and rule-making can be viewed as complementary, mutually-supportive initiatives. This convention can be maintained, at least provisionally. There is, however, a question of context: regionalism is much more attractive as a means to extract the potential gains from trade when it is accompanied by a strong multilateral dynamic that minimizes the margins of preference that RTAs can confer on their participant members and thus minimizes the distortions to the relative prices within those economies.

Moreover, given that the WTO remains the best framework yet achieved to mediate the disputes that routinely arise in the complex global economy that we now have, there is a cost to the diversion of scarce negotiating resources to regional/bilateral pacts that have limited ability to provide the institutional capital to effectively mediate trade conflicts.

Finally, since some of the toughest trade issues, such as those concerning agriculture, can only be addressed adequately within the WTO, the multilateral process necessarily commands a central place in the world of trade policy.

In conclusion, even, and perhaps especially, in a regionalizing world, there is, indeed, a great importance to being multilateral.

Is Secure Trade Replacing Free Trade?

Carolyn Lloyd[*]

Introduction

The global liberal economic regime as we know it affords its participants certain expectations. There is an expectation that economic relations will be carried out following relatively stable patterns, and will not be subject to unexpected challenges that are without limit. We have ostensibly evolved from the trading age of piracy when the contents of vessels were regularly confiscated, a time when violence was considered a "great competitive advantage."[1]

Now, however, it appears we are entering a new, less orderly age—the "age of terrorism." It is not that everyone is determined to undo order in the international system—just a relatively few people.[2] However, a small group is all it takes for terrorism to succeed:[3] the method of "coercive intimidation" by the few.[4]

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[1] Kenneth Pomeranz and Steven Topik, *The World That Trade Created: Society, Culture, and the World Economy, 1400-the Present* (Armonk: New York, 1999), 151.

[2] Estimates range from a hundred to a few thousand, mostly Al-Qaeda, extremists. See Council on Foreign Relations, *Terrorist Financing*, An Independent Task Force Report, 2003.

[3] That not much exertion is required to cause great damage in our high-tech, networked world is exemplified by both the cascade effect and the cultural rogue archetype of the 1990s—the teenaged computer hacker operating out of his parent's basement and causing millions of dollars in losses to busi-

Perhaps the defining word of our post September 11th era is *uncertainty*:

> "No one can possibly imagine in advance all the novel opportunities for terrorism provided by our technological and economic systems. We've made these critical systems so complex that they are replete with vulnerabilities that are very hard to anticipate, because we don't even know how to ask the right questions. [...] Terrorists can make connections between components of complex systems–such as between passenger airliners and skyscrapers–that few, if any, people have anticipated."[5]

And uncertainty has its costs. These will be borne partially by the private sector, in the form of higher costs for security,[6]

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nesses and government agencies with segments of computer codes that are able to penetrate highly-securitized entities. Because it does not take much, or many, to trigger a breakdown, the potential for human loss and the destruction of critical facilities linked to everyday life is huge.

[4] Paul Wilkinson in *The New Fontana Dictionary of Modern Thought*, eds. Alan Bullock and Stephen Trombley, 3rd ed (London: Harpercollins, 1998), 862.

[5] Thomas Homer-Dixon, "The Rise of Complex Terrorism", *Foreign Policy* (January/February 2002): 61. The very act of insulating one component of a system from attack forces attention of would-be attackers to shift towards weaker areas – a never-ending game.

[6] For the merchant ship owners of the seventeenth and eighteenth centuries threatened by piracy, it was "better to increase security by having a larger crew and a lot of gunports than to risk disaster." Pomaranz and Topik, *The World That Trade Created*, 160. Similarly members of today's trading community are taking steps to protect their cargo from being exploited by terrorists. For example, Canada, China, the UK, Japan, the Netherlands, Spain, Singapore and other countries with major seaports have signed onto the Container Security Initiative which was conceived by the United States as a "pre-emptive strike against the smuggling of a weapon of mass destruction" on one of the approximately 200 million sea cargo containers moving across the world's waterways (16 million enter U.S. ports every year). Scott Miller, "U.S. Customs Chief Cites Importance of Container Security Initiative," United States Mission to the European Union document. Internet: http://www.useu.be/Categories/Justice%20and%20Home%20Affairs/Aug2602BonnerContainerSecurity.html; Accessed February 26th, 2003.

partially by governments, as they retool and restructure to counter newly diagnosed threats[7], and partly by society at large as habits and attitudes adjust to the exigencies of the post-September 11th security environment.[8] The key question is how much of the cost will be borne by the trading system and at what cost to economic growth? For Canada, which depends on exports for 41 per cent of its GDP (compared to 10.4 per cent for the United States), 81.8 per cent of that represented by exports to, or through, the United States[9], sells more to the United States than it consumes at home, and shares the largest bilateral trading relationship in the world with the U.S. (CDN$1.55 billion a day in two-way merchandise trade), the stakes are high!

What kind of changes should we expect with the encroachment of security-related regulatory influences into the sphere of trade and what is the significance of those changes? Is this a new era? Are the rules of our rules-based global economic system changing? In short, *is "secure trade" replacing free trade?*

Heeding Robert Baldwin's advice in *The Political Economy of Trade Policy* that "trade policies motivated by broad foreign policy considerations" often need more than an economic self-interest model to explain them, this key question is explored from five perspectives: an official view, an historical view, an economic view, an 'on the ground' view, and a normative view.[10] To arrive at a suitably comprehensive answer to this complex issue, an examination of these five perspectives is undertaken. In the conclusion, we attempt to synthesize an answer.

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[7] For example, the American "homeland" strategy includes building the capacity of first responders (firemen, policemen, etc.), employing information management technology and expanding intelligence gathering, and administrative reorganization (e.g., the establishment of the Office of Homeland Security and Operation LIBERTY SHIELD)

[8] The impact on life in North America after September 11th has been discussed in many essays. See for example Matthew Brzezinski, "Fortress America," *New York Times Magazine* (February 23rd, 2003) and Stephen Flynn, "America the Vulnerable," *Foreign Affairs* (January/February 2002).

[9] Department of Foreign Affairs and International Trade, *Third Annual Report on Canada's State of Trade: Trade Update 2002* (DFAIT: Ottawa, 2002), 7.

Before beginning, general terms must be defined. "Secure trade" is the ensemble of principles, norms, rules, and decision-making procedures[11] that are geared towards preventing terrorism and that require trade to be, in some form or fashion, screened or securitized. Limiting ourselves to examining Canada and the United States, only bilateral secure trade is addressed in this paper (security-related rules governing the exchange of goods and services between Canada and the U.S.). And, because we are exploring only the beginnings of a possible new order, the full "regime" need not be in place—just signs of it. Secure trade has been associated with slower, or less liberal trade; however, this effect need not be inevitable, as we will see, it is not (necessarily) the case.

"Free trade", does not mean trade entirely without restrictions. In general, even when free trade agreements are implemented, imports and exports remain subject to a variety of controls, such as border measures to limit the spread of pests, controls on trade in sensitive military technology, and restrictions on trade in products associated with endangered species (e.g., ivory from elephant tusks). By free trade we mean trade conducted under the conditions established, for example, in the North American Free Trade Agreement (NAFTA).

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[10] Robert E. Baldwin, "The Political Economy of Trade Policy: Integrating the Perspectives of Economists and Political Scientists," in *The Political Economy of Trade Policy: Papers in Honour of Jagdish Bhagwati* (Cambridge, MA: MIT Press, 1996), 150.

[11] This definition borrows from the general definition of a regime developed by international relations scholars, which is "a set of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations." Stephen D. Krasner, quoted in Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton, NJ: Princeton University Press, 1984), 57.

The Official View

Officially, "secure trade" is replacing "free trade" in North America. What is surprising is that trade may now become *freer* (or faster). How can that be?

At first blush, the goals of security and trade seem naturally opposed and difficult to reconcile. Security is associated with regulation, barriers to entry, "high politics." Trade is associated with freedom of enterprise, the removal of barriers, "low politics." One could even go so far as to say that the two aims epitomize the classic divide between politics and economics: as one author mentions, "crisis and war are the dominant factors in international relations, while trade and economic relations are recessive elements."[12]

That there is a distressing downside to global openness has long been known: openness does not just facilitate the movement of products, workers, capital, technology and organizations; it also facilitates the flow of undesirables—biohazards, contagious diseases, narcotics, illicit weapons, and terrorists. However, until recently, it was widely held that an outgrowth of globalization and free trade would be peace: open, friendly borders were understood to foster friendly international relations (the democratic peace thesis[13]).

Few would entertain this idea even lightly now: in light of September 11th, the tension between the two aims of security and trade became acute. That terrorists and trade could share the same arteries became apparent when the Canada-U.S. border was effectively shut down in the days following the terrorist attacks on New York City and Washington, resulting, at some crossings, in 32-km-long backups. As a report by the U.S.

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[12] Gilbert Winham, *The Evolution of International Trade Agreements* (Toronto: University of Toronto Press, 1992), 3.

[13] On the absence of war between liberal-capitalist democracies, see John M. Own, "How Liberalism Produces Democratic Peace" *International Security* 19, no. 2 (Fall 1994): 87-125 and John Macmillan, "Democracies Don't Fight: A Case of the Wrong Agenda?" *Review of International Studies* 22 (1996): 275-299.

Transportation Research Board pointed out, "the nation's vast air, land and maritime transportation systems are marvels of innovation and productivity, but they are designed to be accessible and their very function is to concentrate passenger and freight flows that can create many vulnerabilities for terrorists to exploit."[14]

Policy-makers were forced to find a way to reconcile the needs of security and trade at a time when doing so was most fraught with difficulty. And they did. This official "balance" is one of the most carefully constructed "tightrope-walks" in binational cooperation. We examine below whether the new norms, rules and decision-making procedures portend a new era for trade.

Canadian-American border cooperation in the immediate aftermath of September 11th embodied a certain optimism. It was believed that peace of mind concerning security and the economic health of both nations was, within limits, achievable.

In this spirit, Deputy Prime Minister (then Foreign Minister) John Manley and Tom Ridge, now Secretary of the newly created Department of Homeland Security (then White House Homeland Security Advisor) met in Ottawa on December 12th, 2001 and signed the *Canada-U.S. Smart Border Declaration* with an accompanying 30-point action plan (*Action Plan for Creating a Secure and Smart Border*).[15] The Declaration and Action Plan are blueprints for reinforcing public security and economic security between the two countries. The thought was that "by working together to develop a zone of confidence against terrorist activity"[16] the two countries could tackle new threats in a way that not did not limit, but rather improved, trade.

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[14] Transportation Research Board of the National Academies, *Deterrence, Protection, and Preparation: The New Transportation Security Imperative*, Special Report 270 (Washington DC: Transportation Research Board, 2002), 1.

[15] A similar plan is being developed between the U.S. and Mexico but at a much slower place. While Mexico shares the same free trade space with Canada and the U.S., the US-Mexico border issues are markedly different from the Canada-U.S. context. Thus, they will not be addressed here.

The plan has "four pillars": the secure flow of people, the secure flow of goods, secure infrastructure, and information sharing and coordination.

The two initiatives in the Smart Border Action Plan that most affect trade are NEXUS, part of the secure flow of people pillar, and FAST (the Free and Secure Trade Program), part of the secure flow of goods pillar.

NEXUS is designed to allow Canada and the United States to identify people who are seen as security risks, while expediting the movement of low-risk travellers. NEXUS has obvious ramifications for trade in services, there are thousands or people who travel North or South for work each day, and for tourism (in 2000, a total of 489 million people passed through border inspection systems[17]). An identification card is issued to "pre-approved, low-risk" travellers who are then able to benefit from a dedicated lane to cross the border and are subject to little or no questioning from customs officials (although they can still be subjected to random checks by customs officials). To qualify for a NEXUS card, people must give an electronic scan of their index fingers for comparison against a joint database of immigration violators. Other initiatives related to the secure flow of people include developing a common approach for the screening of international air passengers and co-ordination of refugee/asylum processes.

Even more momentous a change for trade is the Free and Secure Trade (FAST) program. Now operating at six high-volume land border crossings between Canada and the United States, this initiative, designed for commercial shipments, promises to improve *both* security and cross-border efficiency by offering advance clearance for low-risk commercial traffic

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[16] Department of Foreign Affairs and International Trade, "A Strong Partnership: The Canada-U.S. Smart Border Declaration," pamphlet.

[17] Flynn, "America the Vulnerable," 64.

and a "fast lane" for selected trucks at the border. Unknown or higher risk traffic is given a more thorough check. Related endeavours on the movement of goods include in-transit container targeting at seaports, the stationing of customs agents in each other's countries, reverse customs inspections with goods being inspected before they enter a country rather than after and inspection occurring away from the borders in designated areas. Representatives from Canada Customs are currently stationed in Seattle-Tacoma and Newark while U.S. customs officials are stationed in Halifax, Montreal and Vancouver to target containers arriving in those ports that are destined for each other's countries.[18]

On July 15th, 2002, the White House announced a strategy for protecting the homeland, the first of its kind in U.S. history, including the most involved re-organization of the American government in over fifty years. Noteworthy for trade, the Department of Homeland Security gathered together all border, transport and immigration agencies into one agency, combining functions previously managed by Immigration and Naturalization, Coast Guard, Customs, Border Patrol, Federal Emergency Management Agency, Secret Service, Transportation Security Administration, and the border inspection authority of the Animal and Plant Inspection Service. $10.9 billion has been budgeted for securing the land, sea and air borders, with money specifically earmarked for implementing the Smart Border plan. A clearly stated goal of the Department of Homeland Security is to attempt to marry the contradictory stands of "manag[ing] risk in our border and transportation security systems while ensuring the expedient flow of goods, services, and people."[19]

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[18] On June 28th, 2002, in Niagara Falls, Ontario, Manley and Ridge reported on the progress that had been made with respect to the plan–which was considerable in such a short span. At the time of announcement, all of the 30 points had been taken up (although some more than others).

[19] United States Department of Homeland Security, *National Strategy for Homeland Security* (2002), 22.

For its part, Canada created the Anti-Terrorism Plan shortly after September 11th.[20] The Plan's main objectives are to: ensure that the Canada-U.S. border remains secure and open to trade while preventing terrorists from entering Canada, protecting Canadians from terrorist acts, enhancing instruments for identifying, prosecuting, convicting and punishing terrorists, and co-operating with the global community on terrorism-related issues.[21] In the Federal Government's 2001 Budget, the Plan was allocated $7.7 billion over five years, including funds for expenditures on the border for infrastructure, enforcement, intelligence and policing. The 2003 budget provides an additional $75 million for a Security Contingency Reserve over the next two years.

On September 9th, 2002, in Detroit, Michigan, Prime Minister Jean Chrétien and President George W. Bush issued a joint statement on the "Implementation of the 'Smart Border' Declaration and Action Plan." On March 1st, 2003, the new Department of Homeland Security started work.

How does the new "official secure trade" work? There are six "keys" to reconciling the seemingly impossible balance of security and trade.

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[20] Provinces are active too. In April of 2003, a Great Lakes Security Summit will be held in Toronto, hosted by the Minister of Public Safety and Security of Ontario, Robert Runciman. This forum will "renew existing partnerships and joint initiatives, and identify and address new challenges in the areas of preparedness, response and consequence management, cross-border trade, security and counter-terrorism operations." The discussions "will be part of an overall effort to create a more sustainable long-term security strategy to ensure border trade and travel flow smoothly and safely in this vital economic region." Robert W. Runciman, March 25th, 2003, personal correspondence with author.

[21] Department of Foreign Affairs and International Trade, "Compassion and Resolve: Canada's Response to the September 11 Terrorist Attacks," *Canada World View* 14 (Winter 2002), 6.

Risk Management

The first key to reconciling security and trade is effective risk management. The Canada-U.S. border is nearly 9,000 kilometres long. Over 300,000 people cross it[22] each day. A thorough physical inspection of a loaded 40-foot container or 18-wheel truck typically requires 5 inspectors and three hours. Given the enormity of the task involved, day-to-day screening at the border represent a complex and nearly impossible task. Risk management, in practical terms, means permitting pre-approved low-risk vehicles to "speed by" the border so that more time and resources can be devoted to unknown and higher-risk people, shipments and carriers.[23]

Harmonization

Another "key" for keeping the border "open for business but closed to terrorists" is cooperation between Canadian and U.S. border officials. The objective is to reduce transaction costs (by cutting down on duplication of efforts) and building joint enforcement capacity (through information sharing, joint interdiction exercises, and compatible immigration databases and cargo processing systems).

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[22] Notes, North America Bureau, Department of Foreign Affairs and International Trade, 2002.

[23] Stephen Flynn makes the useful comparison of risk management with "anomaly detection" in the computer industry for "detecting hackers intent on stealing data or transmitting computer viruses. The process involves monitoring the cascading flows of computer traffic with an eye towards discerning what is 'normal' traffic; i.e., that which moves by way of the most technologically rational route" and that which is aberrant. Stephen E. Flynn, "The False Conundrum: Continental Integration vs. Homeland Security," in *The Re-bordering of North America? Integration and Exclusion in a New Security Environment*, eds. Peter Andreas and Thomas J. Bierstacker (New York: Routledge, forthcoming 2003), 9.

Technology

New technology designed to enhance security and facilitate the flow of commerce is being deployed in one of the most novel aspects of the FAST program—the ability to provide Customs with the information it needs, electronically, before a shipment arrives at the border. By the time a carrier arrives at the border, Customs can simply read an encoded number from a bar-coded window sticker and instantly transfer information identifying the carrier and its shipment to a customs inspector's computer. One of the more avant-garde ways to bolster security and efficiency in the Smart Border is the use of peoples' unique physiological characteristics to confirm their identity (biometrics). Already, a pilot project at Pearson International Airport and at Vancouver International Airport (CANPASS-Air), which began in January 2003, is set to speed up customs and immigration clearance for travellers to make air travel and processing time faster through the use of the latest iris recognition technology.[24] In addition, technologically upgraded passport readers, x-ray machines and other tracking equipment are to be deployed to help identify terrorists and uncovering dangerous materials in containers and vehicles.

Infrastructure

New commitments involving improved border infrastructure—bridges, tunnels, connecting highways, customs facilities—have been made to help relieve congestion in the medium to long term and to increase security by enhancing service at facilities. A Border Infrastructure Fund of $600 million has been set up the Government of Canada support this aspect of the Smart Border Action Plan.

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[24] "New Customs program using Iris Recognition Technology Makes Clearing Customs Simpler and Quicker," Internet; Press Release; Canada Customs and Revenue Agency; Available at: http://www.ccra-adrc.gc.ca/newsroom/releases/2002/sep/iris-e.html; Accessed November 27, 2002.

Personnel

Without sufficient staffing, the benefits to improving trade and security cannot be accrued.[25] It is imperative that the border officials, on both sides, receive the training and support necessary to implement all facets of the new security measures. Without their vigilance on the ground, any improvements will provide only a false sense of security.

Cooperation with Private Sector

The participation of business is seen as an integral part of the solution. Companies that choose to become part of FAST and NEXUS must upgrade their supply chain security and conduct a security audit. The incentive for companies lies in the fact that those who make this commitment will enjoy the benefits of a fast lane for commercial processing and a reduced administrative burden (streamlined accounting and payment processes for traders using electronic commerce).

In summary, in the words of the responsible Canadian Minister:

> "Our goal was not to just bring the border back to the wait times experienced on September 10th. Our goal was to re-shape the border security foundation using the latest technology and shared intelligence—all guided by the principle of effective risk-management. This allows us to expedite the flow of low risk goods and people and focus our resources on higher risk traffic. The 'smart' in smart border is about not having to

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[25] The passage of the Border Security Bill in the US House of Representatives, H.R. 3525, the Enhanced Border Security and Visa Entry Reform Act of 2002 authorized additional inspectors to ports of entry (the number of inspectors had remained the same since 1986) with improvements already being noted. Canadian Customs official, interview with author, Windsor-Detroit border crossing, Windsor, Ontario, January 22nd, 2003.

choose between increased security and increased facilitation. You can have both."[26]

So, in effect, secure trade is here to stay. The ironic twist is that secure trade may mean free-er trade. For all the worry of the continent "closing in", it looks as if the border is "opening up."

But is that the full story?

The Long View

To assess whether secure trade is replacing free trade from a historical point of view, some perspective is needed.

Many people make much of the fact that the Smart Border idea is not new. This is a point often repeated by those who argue that we are *not* entering a new era; but instead that we are seeing jazzed-up and recycled rhetoric. They are correct in saying that the idea of a smart border is not new. Many of the ideas noted above for improving trade and security at the Canada-U.S. border have been considered before. These ideas were circulating, as we will see, in the bureaus of customs, immigration and transportation officials long before September 11th. However, there *is* something unique about developments on the Canada-U.S. stage that signals that we may be embarking into a new era.

How do we know when something "big" is about to happen in trade policy? Political scientists have developed variables that attempt to explain major public policy change;[27] these can apply in the realm of trade. They are as follows: a functional need for change; a crisis or shock; a change in political leadership; the mobilization of public support; and, at the international level, power politics (the will of the most powerful country—which, in our day and age is the United States).

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[26] "Speech by the Honourable John Manley, Deputy Prime Minister and Minister of Finance, to the Canadian-American Business Council;" September 27th, 2002, Available at http://www.fin.gc.ca/news02/02-076e.html; Accessed March 24th, 2003.

[27] See for example, John W. Kingdon, *Agendas, Alternatives and Public Policies* (New York: Longman, 1997).

At the same time, we can use a comparative lens—contrasting what we see happening now with the dawn of other major eras such as that of free trade between Canada and the United States.

Need for Change

First, what is often witnessed preceding a major change in public policy is simply a compelling *need* for it—a functional explanation. For example, the creation of the Canada-U.S. Free Trade Agreement was preceded by a growing belief in the need for a more predictable trade and investment climate that would contribute to growth, create more and better employment opportunities, as well as to encourage new opportunities for investment. Similarly, in the 1990s, many were already beginning to identify improved border management and trade facilitation as being required to deal with the strains that increases in cross-border trade flows were placing on the border.[28] The expansion in trade far surpassed expectations at the time the Canada-U.S. FTA was signed: Canadian exports to the U.S. expanded by an average of 10.1 per cent *per annum* from 1988 to 2001, with motor vehicles, mineral fuels and machinery topping the list in terms of export commodities.[29]

Prior to the events of September 11th, the focus on border security, particularly from a U.S. perspective, was beginning to shift from immigration-related issues and the war on drugs (particularly at the U.S.-Mexico border) to issues related to facilitating legitimate cross-border commerce. There was much criticism about the border being understaffed. The trajectory of the Smart Border, then, really began in the customs bureaus of both countries with proposals being put forward as early as the February 1995 *Canada/United States of America Accord on our Shared Border*, the February 2000 Office of Inspector General (OIG) report highlighting deficiencies in the INS border patrol along the northern border, and the December 2000 Canada-U.S. Partnership (CUSP) forum report, *Building a Border for the 21st Century*. The 1995 Canada-U.S. Shared Border Accord can be considered a model for the Smart Border Accord

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[28] In the words of Jon Allen, Director of the North American Bureau at the Department of Foreign Affairs and International Trade: "Well before September 11th, 2001, it was clear to most of the people in this room and to many officials on both side of the border that a doubling of our trade since the signing of NAFTA was putting incredible strain on the border: there were infrastructure problems, huge volumes of commercial vehicles and people and inadequate resources." Jon Allen, Speech to the Sarnia Lambton Chamber of Commerce (October 25th, 2002).

[29] Department of Foreign Affairs and International Trade, "Trade with US Regions," in *Canadian Trade Review: A Quarterly Review of Canada's Trade Performance*, Supplement CanadExport, Third Quarter 2002, 4.

However, these plans were not moving forward quickly, functional explanations do not always satisfy as there are many issues that need to be addressed in public life that go unaddressed.

Crisis

Sometimes it takes a shock to overcome institutional inertia and lead to policy change. There are many historical examples:

- The thalidomide controversy and drug safety.
- Martin Luther King's "I Have a Dream" speech and civil rights.
- The École Polytechnique massacre in Canada and the Columbine High School shootings in the U.S. and gun control.[30]
- The discovery of the ozone hole over Antarctica and global negotiations to ban chlorofluorocarbons.

While the seeds of change for security and improving the efficiency of trade at the border were there, it was the September 11th crisis that pushed items from the discussion phase into the action phase.

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[30] Dan Wood and Jeffrey S. Peake, "The Dynamics of Foreign Policy Agenda Setting," *American Political Science Review* 92, no.1 (March 1998), 174.

The "two hours that shook the world" stripped away a belief in American and continental inviolability. ("Some time ago technology and globalization turned that safe and separate 'city on the hill' into an illusion, but it was one we still believed in"[31]). With a sense of "home" safety gone, there were immediate ramifications for the diplomatic, military, intelligence and political fields—not to mention the American psyche. While not everything has changed[32], life in the United States—and indeed the world—will never be quite the same again.

The border crisis in the wake of September 11th fits into the category of "mini-shock." This particular "mini shock" jolted the Canadian economy and Canadian perspectives by precipitating lengthy delays at ports of entry and forcing some Canadian plants to temporarily reduce or shut down production. While conditions at the border improved within days, the desire to avoid any repeat of the situation gave sharp focus to creating and preserving physical and economic security at the border.

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[31] Jessica T. Mathews, "September 11, One Year Later: A World of Change," *Policy Brief*, Carnegie Endowment for International Peace, Special Edition 18 (August 2002).

[32] In the words of Fred Halliday, 'There are two frequent responses to any great historical event, both inappropriate if not downright mistaken: to say that everything has changed and to say that nothing has changed. This was true of the earlier watersheds in the modern history of the world: 1914, 1939, more recently the Iranian Revolution in 1979, the fall of the Berlin Wall in 1989, the Iraqi occupation of Kuwait in 1990. In some respects, society and relations between states went on as before. Beneath a rhetoric of change, states and people went on dealing, trading and living. Indeed, the very drama of these events, even as they precipitated people forward into a new world and into physical and psychological displacement, also drew people back to earlier themes and issues: love and hatred, fear and solidarity, enmities and causes half buried by what seemed to be progress, classic texts of politics, religion, poetry." Fred Halliday, *Two Hours that Shook the World, September 11, 2001: Causes & Consequences* (London: Saqi Books, 2002), 213.

Change in Political Leadership

The forging of the Canada-U.S. FTA was facilitated by the compatibility of the perspectives on economic policy of the governments, which came into power during the 1980s (the Mulroney government in Canada and the Reagan Administration in the U.S.). Similar compatibility of economic philosophies prevailed in the 1990s, which saw the signing of the NAFTA by Prime Minister Jean Chrétien and by President Bill Clinton. But, with political transition in the U.S. and political continuity in Canada, the political climate changed. Differences in political leanings have been exacerbated by trade frictions (e.g., softwood lumber, dairy and most recently the Canadian Wheat Board) and by differences in approach to the enforcement of UN resolutions concerning Iraq. However, the profound interest of both countries in avoiding disruption to the economy, supported by business on both sides of the border, and the breadth and depth of cooperation at the Ministerial and agency-department levels allowed rapid implementation of the new measures. One would not, however, conclude that political change played a key role in propelling change in this instance.

Mobilization of Public Support

Fourthly, a sign of change can be found in an upsurge in political interest and pressure from the public. When something big is happening in the world of trade, people who do not normally concern themselves with trade, begin to. In the 1980s:

> "[t]he bilateral agreement between Canada and the United States sparked a heated debate in the Canadian public that was reminiscent of an earlier age when the tariff was a staple of electoral politics. For modern scholars of international trade, the sudden attention to trade policy was wholly unexpected. Studying most issues of public policy is a little like researching earthquakes: tranquility is the normal state, but when activity occurs, interest becomes insatiable, and anyone

possessing a passing knowledge of the subject experiences the flattery of public attention."[33]

Today, debates and conversations about our relationship with the United States fill the airwaves and are the subject of a number of television programs. Canadians from all walks of life are being reminded of the importance of trade with the U.S. to the Canadian economy. An Ekos survey of Canadians conducted between January 26th and February 6th, 2002 found that people are aware of, and interested, in Canada-U.S. issues, trade, and security—and are generally supportive of greater harmonization with regards to both border security and trade facilitation.[34]

Just as momentum in favour of free trade with the United States began to develop in the 1980s, led by such groups as the Economic Council of Canada, the Standing Senate Committee on Foreign Affairs, the C.D. Howe Institute and those involved with the Macdonald *Commission's Report on the Economic Union and Development Prospects for Canada* (1985), many groups are now agitating for change with respect to Canada-U.S. trade relations (on free and secure trade). Consider these initiatives:

- The House of Commons Standing Committee on Foreign Affairs and International Trade included border issues on its agenda and prepared a report on border cooperation *(Towards a Secure and Trade-Efficient Border)*, highlighting the question of secure trade.[35]
- A flurry of attention accompanied the announcement by Thomas D'Aquino, head of the Canadian Council of Chief

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[33] Winham, *Evolution of Trade Agreements*, viii.

[34] Department of Foreign Affairs, "Canadians on North American Integration." (April 11th, 2002).

[35] House of Commons Standing Committee on Foreign Affairs and International Trade, Report of the Sub-Committee on International Trade, Trade Disputes and Investment, Towards *a Secure and Trade-Efficient Border*; November 2001; Available at http://www.parl.gc.ca/InfoComDoc/37/1/FAIT/Studies/Reports/sintrp05-e.htm

Executives, on "reinventing" the borders and forging a new Canada-U.S. partnership by eradicating as many of the barriers to the movement of people and goods across the countries' internal borders as possible, and by shifting attention to the protection of approaches to Canada-U.S. from other countries. His ideas made headlines:

> "Canadians must take the lead as we did two decades ago, when we stood at yet another critical crossroad. At the time, the crisis was not global terrorism. It was trade protectionism. We opted fo[illegible] bold new vision—the Canada-United States [illegible] Trade Agreement. On this choice, history has offered decisive proof. Canada and the United States made the right decision. We must make the right decision again."[36]

- The Coalition for Secure and Trade-Efficient Borders, composed of 45 Canadian business associations and individual companies, was formed to assist the federal government, through dialogue and cooperation with industry, in dealing with the trade and security border issues. The aims of the Coalition are to recommend measures that facilitate the passage of low-risk goods and people across Canada's borders; strengthen Canadian security, immigration and border management; and increase cooperation between Canada and the U.S. and other countries to prevent the entry of terrorists, illegal immigrants, contraband and illegal goods into the two countries.[37]

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[36] Thomas D'Aquino, "Security and Prosperity: The Dynamics of a New Canada-United States Partnership in North America," Presentation to the Annual General Meeting of the Canadian Council of Chief Executives (January 14th, 2003), Toronto, Notes.

[37] Coalition for Secure and Trade Efficient Borders, *Rethinking our Borders: A Plan for Action* (December 3rd, 2001), ii. The Coalition is led by the heads of the four major horizontal business associations in Canada – the Canadian Manufacturers & Exporters, the Canadian Chamber of Commerce, the Business Council on National Issues and the Canadian Federation of Independent Business. (This report, and its predecessor, *Rethinking Our Borders: A Plan for Action*, available at http://www.cme-mec.ca/coalition/).

- The CD Howe Institute has been vocal on the need to develop a "big idea" for secure trade and has begun a series of papers called "The Border Papers" to promote discussion on trade, integration and security in North America.[38]
- Various chambers of commerce in both Canada and the U.S. have organized *ad hoc* groups and discussions on how secure trade might affect business. Members of the Americans for Better Borders Coalition (part of the U.S. Chamber of Commerce) are of the mind that "Congress and the border agencies (INS and Customs) need to evaluate any new measures implemented at the border for their potential negative impact on legitimate commerce, while maintaining the need for security." They state, "We believe that our borders can and should be a line of defense against those who pose security threats to this country, but borders must also allow for legitimate commerce and travel. Efficient allocation and use of technology, personnel and infrastructure resources can achieve both of these goals."[39]
- The academic Quarterly *Ideas That Matter* and the Munk Centre for International Studies at the University of Toronto, with the cooperation of several Canadian public policy think tanks such as The Institute for Research on Public Policy and the Donner Canadian Foundation, have sponsored a series of "Borderlines" conferences in cities across the country with the theme "Canada in North America."[40]
- The Canadian/American Border Trade Alliance has developed a strategy called "perimeter clearance" which the organization has outlined in its report, *Perimeter Clearance*

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[38] The Border Papers are available at www.cdhowe.org.

[39] See www.chamber.ca for the Canadian Chamber of Commerce website with articles on the subject of the border and http://uschamber.com for the U.S. Chamber of Commerce website, including information on the Americans for Better Borders Coalition.

[40] Information about the "Borderlines" conferences is posted at http://www.borderlines.ca.

Strategy: To Realize a Smart Border for the 21st Century (April 2002).[41]

- A group of eminent persons, led by Peter McPherson, President of Michigan State University sent a letter to President Bush and Prime Minister Chrétien advising on ways to have the border remain seamless and secure.[42]

While the issue has become a platform for some advocating greater North American integration[43], a security perimeter[44], a customs union[45], or a common currency,[46] the majority of groups are simply fighting for more resources and attempting to raise the profile of secure trade.

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[41] For detail about the Canadian/American Border Trade Alliance and the "perimeter clearance" strategy see www.canambta.org. Jim Phillips, President and CEO of the Canadian/American Border Trade Alliance stresses that his alliance's strategy is not the elimination of the Canada-US border nor is it the creation of a customs union; rather, the alliance's "vision" is this: "the US and Canada working together to strengthen protection of the external borders and expediting the movement of low-risk people and goods at the common border between the two countries. Jim Phillips, interview with author, Department of Foreign Affairs, February 24th, 2003.

[42] Peter McPherson, James Blanchard, Carol B. Hallett, Roger B. Porter, John P. Simpson, John F. Smith, Jr., Bob Stallman, Robert Teeter, J. Robinson West, George Weyerhauser, Derek Burney, David L. Emerson, James K. Gray, Michael Hart, Stanley Hartt, M. Daniel Johnson, Thomas Kierans, Angus Reid, David W. Strangway and Paul Tellier, "Letter to President George W. Bush and the Right Honourable Jean Chrétien," (November 26th, 2001), Michigan State University News Releases.

[43] Wendy Dobson, "Shaping the Future of the North American Space: A Framework for Action," *C.D. Howe Institute Commentary*, no. 162 (April 2002); Michael Hart and William Dymond, "Common Borders, Shared Destinies: Canada, the United States and Deepening Integration," Centre for Trade Policy and Law; Internet Paper; Available at http://www.carleton.ca/ctpl/borders/hartdymondweb.htm; Accessed November 27th, 2002.

[44] Stéphane Roussel, "Le Canada et le périmètre de sécurité Nord-Américain: Sécurité, souveraineté ou prospérité?" *Policy Options* (April 2002), 15-22.

[45] Rolf Mirus and Nataliya Rylska, "Economic Integration: Free Trade Areas vs. Customs Unions" in *NAFTA and the New Millenium*, ed. P. Smith (2003), forthcoming.

Power Play

Finally, what a world power wants it usually gets. In the grand sweep of international relations, according to the hegemonic stability theory, the dominant power dictates the rules and sets the order.[47]

So what does the United States want? Certainly, the country possesses "a revived sense of mission" (the defeat of global terrorism).[48] At the same time, it is not in America's interest to forego economic security, which is well appreciated in the Administration as well as in the business community.

Although it is often stressed how much Canada needs the U.S. in trade terms, the U.S. needs Canada nearly as much: Canada is the U.S.'s largest export market—larger than Japan

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[46] Thomas J. Courchene, "The Case for Currency Union," Background Statement Presented at Borderlines: Canada's Options in North America, Montreal (November 1-2, 2002).

[47] When the theory of hegemonic stability was first formulated by Charles Kindleberger, it offered a cogent interpretation of the creation of free trade regimes in the mid-19th and mid-20th centuries during the *Pax Britannica* and *Pax Americana*, respectively. The singular impact of Great Britain and the United States on the development and enforcement of a set of monetary rules, institutions and procedures was helped by the fact that they were both, in their time, the undisputed economic heavyweights. Not only were they strong, they were willing to assume the leadership role, possessing as they did an invested interest in the proliferation of classical liberalism, a system that relies first and foremost on a free market with the minimum of barriers to the flow of private trade and capital. Charles P. Kindleberger, "Systems of Economic Organizations," in *Money and the Coming World Order*, ed. David P. Calleo (New York: New York University Press, 1976) and Robert Gilpin, *The Political Economy of International Relations* (Princeton, NJ: Princeton University Press, 1987): 72-77.

[48] Robert W. Tucker, "The End of a Contradiction," Special Issue: One Year On: Power, Purpose and Strategy in American Foreign Policy," *The National Interest* (Fall 2002): 6.

and larger than all 15 European Union countries combined,[49] with 39 of the 50 states having Canada as their largest partner in merchandise trade. There will most likely be a push for both physical and economic security in the both the short and medium term.

Several of the five factors are coming together in the sphere of trade and security at present, making secure trade seem very likely from an historical point of view.

The Economic View

Economically-speaking, are there telltale signs that secure trade is replacing free trade? It is important to make some distinctions in the literature.

Work in the literature to date is divided into four categories:

(a) Studies examining the effects of September 11th on trade and the world economy;
(b) Studies examining the effects of potential future terrorist disruptions;
(c) Studies examining new security-related measures in terms of a "security tax"; and
(d) Studies examining the effects of a permanent new regime of secure trade, which could include the possibility of faster border transit.

The last category is the most interesting, but unfortunately also the one on which the least amount of work has been done thus far. This is quite understandable, as it really is too soon to make definitive qualitative or quantitative assessments concerning the impact of new institutional arrangements that are still being put into place. This is not to say that it not important to consider what lies ahead for trade policy, however, reviewing the first three areas will give us an idea of how to respond to the last.

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[49] Michael Den Tandt, "Trade as Crucial to the U.S. as to Canada," *Globe and Mail* (March 27th, 2003), pg B2.

Effects of September 11th

Many studies have already tried to examine the economic effect of September 11th on business and trade.[50] It was initially feared that the terrorists attacks would wreak havoc on the global economy as the U.S. economy virtually shut down for several days and stock markets plummeted worldwide. It did not. While, the third quarter GDP in the U.S. was knocked down by perhaps as much as one percentage point, with airlines, civilian aircraft manufacturers, hotel, tourism, retail trade, insurance, and postal services suffering the most, stock markets rebounded sharply and part of third quarter decline in economic activity was recouped in the fourth; globally, the short-term effects were more muted. Overall, the global economy after September 11th has proved to be remarkably resilient. To the extent that global growth has been disappointingly weak, it is widely thought that other factors (including, for example, the erosion in confidence due to events such as the accounting scandals in the United States) were largely responsible.

Effects of Potential Future Terrorist Disruption

Other studies have examined the question as to whether goods and services will continue to be able to move across national borders safely and dependably in the event of a further terrorist disruption.

Danielle Goldfarb and William Robson have ventured some first guesses on how border closures and other disruptions related to a future terrorist attack would likely affect key sectors of the Canadian economy. The authors estimate that border disruptions could affect up to 45 per cent of Canada's exports, 387,000 jobs and $2.5 billion in investments.[51]

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[50] See for example, Dean C. Alexander and Yonah Alexander, *Terrorism and Business: The Impact of September 11, 2001* (Ardsley, NY: Transnational Publishers, 2002), Patrick Lenain, Marcos Bonturi and Vincent Koen, *The Economic Consequences of Terrorism*, Economics Department Working Papers No. 224, Organization of Economic Cooperation and Development (July 17th, 2002) and a series of commentaries by Dan Ciuriak, "The Economic and Trade Impacts of September 11", Trade and Economic Analysis Division, Department of Foreign Affairs and International Trade (2001).

Perhaps the most worrisome potential impact is on international foreign investment. Foreign investors who might be considering Canada as a gateway to the North American market, would have to take into account the risk of less secure and more costly access to the United States. Concerns that a tighter border could result in sufficiently costly delays (and perhaps more importantly, raising uncertainty about the time and process for transiting goods across the border), would favour investment in the larger market, namely the United States. In this context, some of the gains from trade deriving from fragmentation across borders to take advantage of specialization in production might be reduced as "just-in-time" becomes "just-in-case." This would expand the existing degree of "home-bias" in both Canada and the United States, to the detriment of bilateral trade. At the same time, particularly in services, one cannot entirely discount the possibility that some FDI into Canada from the United States (or vice-versa) will increase simply to avoid having to deal with border issues. In other words, Mode 3—commercial presence—would become more favoured over other modes.[52] Less likely, the latter effect (i.e., separate plants to serve the separate countries) could also be visible in goods trade, especially where scale economies are relatively unimportant.

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[51] See Danielle Goldfarb and William B.P. Robson, "Risky Business: U.S. Border Security and the Threat to Canadian Exports", *The Border Papers*, C.D. Howe Institute, No. 177 (March 2003).

[52] For a full discussion of services trade issues, including the various factors that bear on the choice of the mode of carrying out such trade, issues in the measurement of barriers to services trade, and an overview of Canada's services trade performance under the four alternative modes, see chapters 4 to 6 in John M. Curtis and Dan Ciuriak (Eds.) *Trade Policy Research 2002* (Ottawa: Department of Foreign Affairs and International Trade, 2002), respectively: Brian R. Copeland, "Benefits and costs of trade and investment liberalization in services: Implications from trade theory", pg 107-217; Ziqui Chen and Lawrence Schembri, "Measuring the Barriers to Trade in Services: Literature and Methodologies", pg 219-286; and Shenjie Chen Trade and Investment in Canada's Services Sector: Performance and Prospects", pg 287-347.

Reflecting these concerns, Goldfarb and Robson note, "If security concerns make the border more of an obstruction to commerce, some companies that previously planned to produce in Canada to serve their U.S. operations or their U.S. consumers may add to their capacity in the United States instead."[53]

A much-quoted study by David J. Andrea and Brett C. Smith[54] shows the vulnerability of the auto industry in the event of a terrorist disruption. The report charts the significance of keeping components flowing across the border due to just-in-time deliveries (JIT).[55] The authors record that "automotive-related exports account for nearly 20 per cent of all of Canada's exports to the United States, with automotive-related imports accounting for an equal 20 per cent of all of Canada's imports from the United States."[56] Canadian-U.S. automotive-related trade was valued at U.S. $78.2 billion in 2000.[57] Canadian automotive trade activity with the United States equates to 97 percent of all Canadian automotive exports and 79 percent of all Canadian automotive imports. This kind of interdependence means efficiency at Canadian-U.S. crossing points is of paramount importance. "Before the tragic events of September 11th, logistics managers developed the current system of JIT logistics around a 20 to 30 minute time window to clear materials through the Canadian-U.S. border. [...] To move outside this time window threatens vehicle assembly plant profits in the range of $60,000 per hour and U.S. $7,500 to U.S. $2,000 per hour at the major first tier component plants (on an individual basis)."[58]

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[53] *Ibid.*, 13.

[54] David J. Andrea and Brett C. Smith, *The Canada-US Border: An Automotive Case Study*, Center for Automotive Research and Altarum Institute (January 2002).

[55] JIT is a system whereby components are sent to production sites only as they are needed to save on warehousing costs.

[56] *Ibid.*, 3.

[57] *Ibid.*, 1. A combined figure from US $43.6 billion in trade of vehicles and US $34.6 billion in trade of automotive parts.

Effects of Security as a Security Tax

Confidence in the ability to move goods and services across national borders affordably and quickly has also declined due to the *responses* that have been taken to prevent terrorist disruption, according to a number of authors. Expenses like inventory, insurance, administrative, transport and distribution (conceived as a "security tax") are increasing, and influencing, global supply chain performance. A body of literature stimulated by research conducted, separately, by John Helliwell and John McCallum has a lot to tell us on this matter and shows us that the "border effect," even without security considerations, is surprisingly high.[59]

Even before September 11th, the average non-tariff border cost is said to represent approximately 5 per cent of the final invoice price of a given product. For trade-sensitive industries, the cost is thought to be as high as 10-13 per cent.[60]

The Economic Strategy Institute estimates that the cost in the U.S. of the "new level of security could amount to one-half of one percent of the U.S. gross domestic product or approximately \$51 billion annually."[61] The Organization of Economic Development and Co-operation, for its part, found that security measures might augment the *ad valorem* cost of trading internationally as much as 1 to 3 percentage points. The OECD adds, "given that the elasticity of trade flows with respect to transaction costs may be in the –2 to –3 per cent range, this could lead to a significant drop in international trade, negatively affecting openness, productivity and medium-term output growth. Thus, the right balance between efficiency and security at the border needs to be found, preferably in agreement with trading partners and on a non-discriminatory basis".[62]

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[58] *Ibid.*, 18.

[59] The "border effect" is the empirical regularity that transactions are far more likely to take place between two regions within the same country as opposed to the situation where an international border must be crossed, controlling for population size, incomes etc. This can reflect unobserved trade costs. See John F. Helliwell, *National Borders, Trade and Migration*, Working Paper 6027 (Cambridge, MA: National Bureau of Economic Research, 1997); John McCallum, "National Borders Matter: Canada-US Regional Trade Patterns," *American Economic Review* 85 (June 1995): 615-23; John M. Curtis and Shenjie Chen, "Trade Costs and Changes in Canada's Trade Pattern," Forthcoming, 2003, and James E. Anderson and Eric van Wincoop, *Borders, Trade and Welfare*, Working Paper 8515 (Cambridge, MA: National Bureau of Economic Research, 2001).

[60] Andrew Shea, "Border Choices: Balancing the Need for Security and Trade," Special Report, Conference Board of Canada (October 2001), 2.

Effects of a Permanent Secure Trade Regime

The likelihood and effects of "the right balance" is what we are most interested in. As we can see from the literature on security costs, there is a lot to overcome in solving security-related challenges and alleviating concerns in the trading community. Of course, if the Smart Border initiative is seen to be effective, these fears will be lessened—and order (a new order, replacing the uncertain one) will prevail, ultimately reducing time in transit for goods and services. What the above studies do not consider, however, is how a state of permanency will influence trade. The studies assume that economic drawbacks associated with flux will always be present and forget or discount the possibility that the war on terrorism, unlike other wars that end after weeks, months or years, could possibly last indefinitely. In the words of U.S. Vice President Dick Cheney, "heightened security and constant vigilance are the new normalcy."[63] Presumably, there will be time to adjust.

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[61] Economic Strategy Institute, quoted in Garrett Wasny, *September 11 and International Trade: How 9/11 Changes Global Business* (2002), 5.

[62] Leanin et al., "Economic Consequences," OECD, 5.

[63] V.P. Dick Cheney, in Bob Woodward, "Cheney Says War Against Terror May Never End," *Washington Post* (October 21st, 2001), A1.

Will the Smart Border make any difference once fully implemented?

Statistical data are not yet available that could reflect any significant change, either positive or negative. It is fair to say that large firms may gain more than small firms, as secure trade seems already to be changing the competitive playing field. While any company that can provide accurate data, documents and consistent compliance with new trade regulations stands to win by having its shipments fast-tracked (a sure competitive advantage), larger firms can handle these new challenges better than smaller firms due to greater trade volume and capital resources. As if to prove the point, the first companies to have signed up for FAST are Ford Motor Company, General Motors, DaimlerChrysler, Target, Sara Lee Corporation, Kodak Canada, and Dupont.

To summarize, economically, we do not yet understand the ramifications of "secure trade" on growth. Although long-term predictions lead us to conclude that we might be seeing freer trade, as the official view promises, we will have to wait and see. Nevertheless, there are clear downside risks as the cost of undertaking international trade has increased.

The 'On the Ground View'

A visit to one crossing point in particular reveals many "roadblocks" currently facing secure trade—both figurative and literal. The Ambassador Bridge connecting Windsor and Detroit was so named to "symbolize the visible expression of friendship of two peoples with like ideas and ideals."[64] The United States exports more over the Ambassador Bridge than it does to China, Germany or the United Kingdom. For Canada, the bridge represents an even more critical link: approximately eight per cent of Canada's gross domestic product is derived from exports that travel over that bridge.[65]

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[64] Named by builder, Joseph Bower. Information available at http://www.ambassadorbridge.com/facts.html.

All told, in a year, over 32 million vehicles, cars and trucks cross the Ambassador Bridge, Blue Water Bridge and the Detroit-Windsor Tunnel. Truckers have an expression, "If you've got it, we brought it." By value, eighty per cent of goods moving between Canada and the United States are carried by trucks and railways.[66]

As FAST is designed from the framework of existing supply chain security programs—Customs Self Assessment and Partners in Protection (CSA/PIP) in Canada and Customs Trade Partnership Against Terrorism (C-TPAT) in the United States, many carrier companies have been slow to make the switch.[67] And unlike its predecessors, participants must pay to be a part of FAST. Companies are attached to CSA/PIP and C-TPAT and as long as they can still use those systems, they will. FAST was implemented on December 13th 2002 at the Detroit-Windsor border crossings.

But things are changing.

The FAST dedicated lane is now up and running. General Motors presently uses 600 FAST trucks a week at the three major ports in Detroit, Port Huron and Buffalo. By the end of March 2003, there were 1,100 FAST/C-TPAT approved importers and about 100 carriers registered. Calls are being made daily by U.S. Border and Customs Protection to already pre-approved drivers to get them to complete the process (by going for an interview at the enrolment centre) and join.

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[65] John Lippert and Erik Schatzker, "Matty's Bridge," *Bloomberg Markets* (March 2003), 77.

[66] Shea, "Border Choices," 2.

[67] Rufus Mills, a trucker from Alabama employed by Falcon Transportation and Forwarding Corp, is just one of 31 commercial carriers who, by January 23rd, 2003, had enrolled at the FAST program. There his citizenship documents are reviewed, he is fingerprinted and has a digital photo taken (his FAST commercial driver application having already been risk-assessed by the customs and immigration authorities from both Canada and the U.S). While he will soon receive a FAST Commercial Driver card, he remains unenthusiastic about the entire process, being concerned only about getting his delivery in on time. The benefits of secure trade, from his vantage point, are still hard to discern.

And while NEXUS initially opened with little fanfare at the Ambassador Bridge (local newspapers failed to report the event the next day), Canada Customs and Revenue Agency, Citizenship and Immigration Canada, the United States Immigration and Naturalization Service and United States Customs Service were ready the next time around when NEXUS opened at the Detroit-Windsor tunnel.[68]

Many groups had anxiously awaited the opening of NEXUS—for example, Canadian nurses working in Detroit-area hospitals. "Since 9/11, we deal with the daily unpredictability of whether it will take 20 minutes or two hours to get across the border to work," explains Mary Anne Rizza, recruitment specialist for St. John Health System in Detroit. "The delays impact us not only in our personal lives—we all have families—but also impact our co-workers who cannot end their shifts until the next shifts arrive. All of us anxiously await[ed] the opening of this program."[69]

Windsor is still suffering from post September 11th losses although much of the problem is related to difficulties with traffic routing, and not security. Border congestion was a major problem before September 11th at the Windsor-Detroit crossing, and remains an even greater problem after. However, with overall traffic volumes down, wait times are slightly less than they were before September 11th (and certainly a lot less than they were in the days immediately after September 11th). Tourism is currently in decline—fewer Americans are crossing the border to visit the casino[70], restaurants and other once-popular destinations in Windsor. Windsor, like many border communities in both Canada and U.S., is highly susceptible to what happens at the border. "Every day is a struggle," explains Windsor Mayor Michael Hurst.[71]

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[68] A notice to the media was circulated beforehand and a ribbon-cutting ceremony by Rocco Delvecchio, the Consul General of the Canadian Consulate in Detroit was held to mark the event, along with a demonstration of the technology used in the NEXUS lane.

[69] Mary Anne Rizza, quoted in "Technology at the Border: NEXUS and FAST are speeding the flow of People and Goods at the Ambassador Bridge, Blue Water Ridge and the Detroit-Windsor Tunnel," *Detroiter* (January/February 2003): 30.

On the highways, at seaports and at railyards, there is still much work to be done across the continent. Secure trade is taking hold on the ground—but slowly.

The Normative View

Finally, we ask, *should* secure trade replace trade? What are the normative implications of securitized trade? If we limit ourselves to an inquiry on whether or not secure trade should replace free trade, what would the answer be?

There are several principles at stake. How they are weighed and evaluated weighted by key players will likely determine the shape and outcome of secure trade.

A 1975 article foresaw trade-offs for living in an age of terrorism. David Fromkin wrote, "In our personal lives we sometimes have to choose between these alternatives: whether to live a good life or whether to live a long life. Political society in the years to come is likely to face a similar choice." Worrying that an open society seemed to expose us and "threaten us with every more dreadful and drastic fates," he asked, "have we the stoicism to endure nonetheless? Will we be tempted to abandon our political and moral values? Will we be willing to go on paying an ever higher price in order to defeat the terrorists by refusing to respond in the way they want us to?"[72]

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[70] As one author puts it, "every night, the powerful beams from rooftop spotlights crisscross the sky above Casino Windsor, as if searching for the thousands of Americans who used to flock here in a daily pilgrimage of chance." Tim Jones, "Windsor Businesses Feel Security Pinch," *Chicago Tribune Online Edition*; Internet Article; October 8, 2001; Available at www.chicagotribune.com/news/showcase; Accessed on January 8th, 2003.

[71] Michael Hurst, Mayor of Windsor, interview by author, Windsor City Hall, Windsor, Ontario, January 22nd, 2003.

Maintaining world trade is a more important than ever, cite some. The argument follows that if we are to fight terrorism, we have to fight by maintaining economic growth and by not sacrificing the value of an orderly, open economic society for a closed order.

This argument—let's preserve our values so as not to let the terrorists "win"—was taken up by Richard Zoellick, U.S. Trade Representative in a much-talked about editorial appearing in the *Washington Post*. Titled "Countering Terror With Trade," the article postulated that America and its allies should defiantly defend the values "at the heart of this protracted struggle." Zoellick felt that trade is about "more than economic efficiency." Trade, he wrote, fits into a larger framework of values that "define us against our adversary: openness, peaceful exchange, democracy, the rule of law, compassion and tolerance."[73]

Even as the nation mourned, the U.S. Trade Representative pleaded for a message to be sent out to the world that economic growth would not be impeded and that hope for the future had not been extinguished. Zoellick urged the administration of which he was a part to "shape history by raising the flag of American economic leadership," just as Franklin D. Roosevelt had done to roll back protectionism during the Great Depression.[74]

Extra resonance for this argument is drawn from the fact that the September 11th attacks were, quite literally and startlingly, an attack on trade (and finance) itself. The World Trade Centre (WTC) housed brokers, insurance companies, retailers, bankers, lawyers, agents, and many who provided essential trade services—and was considered a hub of trade. The World Trade Center Association to which the New York WTC belonged brings together exporters, importers and service providers in almost 100 countries (there are a total of 300 WTCs).[75]

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[72] David Fromkin, "The Strategy of Terrorism," *Foreign Affairs* 53, No. 3 (April 1975): 697-698.

[73] Robert B. Zoellick, "Countering Terror with Trade," *Washington Post* (September 20, 2001): pg A35.

[74] *Ibid.*

In an article called, "Why You?" Michael Lewis writes:

> "The sort of people who work in financial markets are not merely symbols but also practitioners of liberty. They do not suffer constraints on their private ambitions, and they work hard, if unintentionally, to free others from constraints. This makes them, almost by default, the spiritual antithesis of the religious fundamentalist, whose business depends on a denial of personal liberty in the name of some putatively higher power."[76]

The Economist penned, "it's hard to exaggerate the courage" shown by firms in the financial sector who had business up and running just two days after the attacks like Cantor Fitzgerald, a leading "inter-dealer broker" in the government bond market which lost 658 of 1,000 of its New York employees on the morning of September 11th.[77] That same courage has propelled firms, to this date, to not let trade and the free market down.

That jobs are on the line if we batten down the hatches on the continent holds sway in business and industry circles. Often acknowledged by such groups is the fact that the traffic that flows back and forth across our border on a daily, weekly and yearly basis is the lifeblood of the global economy. It creates the jobs and produces the wealth upon which many depend. In Ontario alone, close to one million jobs depend on exports to the United States. Two-trade between Ontario and its neighbouring state, Michigan, equalled more than $97 billion in 2000.[78]

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[75] "About World Trade Centers Association," For more information see http://iserve.wtca.org/awtc/about.html

[76] Michael Lewis, "Why You?" *New York Times* (September 23rd, 2001).

[77] *The Economist*, "Carrying On," (September 22nd, 2001).

On the other hand, some people, especially in Washington circles, are concerned that paying too much attention to trade facilitation as well as enforcement will take away from security.[79] The attention to trade facilitation in the Smart Border Accord did not escape the critical gaze of Matthew Mingus:

> "The rhetoric [of the Smart Border] is that an efficient flow of routine trade and traffic will allow border officials to focus on 'higher risk' individuals and freight. This makes good sense; however, an unintended consequence of such a policy may be an increase in the concentration of trade and tourism through a limited number of border crossings."[80]

Increased concentration at the border without enough security could prove to be very dangerous indeed.[81]

As much as no one wishes to expose the continent to extreme levels of risk, some ask: what is the price of security? In stepping up security measures, there are unavoidable trade-offs for civil liberties and sovereignty.[82] The losses of civil liberties and the inauguration of a "big brother" epoch—intrusive surveillance, redefining due process—have been especially discussed.[83] The "expansive philosophy"[84] of proactive enforcement law is concern to a number of Americans used to living in a country where personal freedom is more reverently guarded than anywhere else in the world.

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[78] Infrastructure Canada, "$300 Million Canada-Ontario Investment at the Windsor Gateway," Internet News Release (September 25th, 2002). Available at www.infrastructurecanada.gc.ca/bif/publication/newsreleases. Accessed January 13th, 2003.

[79] Hillary Clinton, "Border Security is Homeland Security," Internet Letter (October 16th, 2001); Available at http://clinton.senate.gov/news; Accessed November 29th, 2002.

[80] Matthew S. Mingus, "Economic Security Not So Cheap as *Smart Border Declaration* Implies: Suggestions for Long-term Trade Deconcentration on the Canada-U.S. Border," Submission to *Journal of Borderland Studies* (November 2002), pg 1.

[81] Two of the world's leading experts on nuclear weapons, Graham Allison and Andrei Kokoshin, tell us: "Could a nuclear terrorist attack happen today? Our considered answer is: yes, unquestionably, without any doubt. It is not only a possibility, but in fact the most urgent unaddressed national security threat to both the United States and Russia." Graham Allison and Andrei Kokoshin, "The New Containment: An Alliance Against Nuclear Terrorism," *The National Interest* (Fall 2002), pg 35.

Clearly, what is at stake, normatively, *is getting the balance right.* In that sense, secure trade should and probably will (insofar as these factors are known and accepted by decision-makers) replace the current regime.

Conclusion

Over the past half-century, through various rounds of bilateral, regional and multilateral negotiations (including the one currently underway since its launch at Doha, Qatar), countries have attempted to adjust their policies to gradually produce as calming (and thus prosperous) a result as possible for international society—that "one common tie of interest and intercourse",[85] otherwise known as free trade. While not perfect, the world has come a long way.

Then, with the advent of a new uncertain age, imperilled by terrorism, Canada and the world have been forced to change the way trade was conducted. Order was threatened. A surprising development was that trade was in the first instance only moderately affected. Secure trade is on its way to replacing the old concept of free trade—but trade ironically might now be freer in addition to more secure.

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[82] The loss of sovereignty is especially a concern for Canadians—will increased cooperation with the US cause our border to vanish? Drew Fagan, "It's the year 2025…There is no U.S. Border; Has Canada become the 51st state?" *Globe and Mail* (March 16th, 2002); Internet Article; Available at http://www.globeandmail.com/series/borders; Accessed January 6th, 2003.

[83] *The Economist*, "A Question of Freedom," (March 8, 2003), 29-31.

[84] Jonathan Stevenson, "How Europe and America Defend Themselves", *Foreign Affairs* 82, No. 2 (March/April 2003), pg 78.

[85] David Ricardo, quoted in Robert Gilpin, The *Political Economy of International Relations*, (Princeton, NJ: (Princeton University Press), pg 174.

The Smart Border has been called the "border for the future" and a "model for the world."[86]

While it is too soon to measure the impact of a possible new secure trade regime, an examination has been undertaken above to establish whether or not something new was on the horizon—a new global economic order in the form of secure trade. How would officials answer the question? Historians and political scientists? Economists? Those on the front lines—the customs broker, the trucker, the patrolman? Those living in border communities? Arbiters of ethics? All say yes.

While this paper focused on the North American dimension of trade and security—there are repercussions for the world. Indeed, this problem goes beyond hemispheric—as George Haynal of the Canadian Council of Chief Executives in Ottawa recently stressed, "We have got a global problem on our hands." In a post September 11th context, Canada-U.S. security and trade "is everybody's business."[87] The American perimeter is moving outwards from U.S. national boundaries to foreign points of departure and most countries—not just the U.S. and Canada—are becoming more stringent in verifying the security of supply chains. A new secure trade regime, for example, was formed in the APEC region: the Secure Trade in the APEC Region (STAR), agreed to at the 2002 APEC Economic Leaders' Meeting in Los Cabos. We see agendas once devoted to economics focusing more and more on security concerns, as we seen at the G-8 Summit in Kananaskis in June, 2002.

A new era for trade has begun.

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[86] Tom Ridge, Press Release, June 2002.

[87] George Haynal, Senior Vice President, Canadian Council of Chief Executives, interview by author, CCCE Headquarters, Ottawa, Ontario, January 28th, 2003.

Part II:

Systemic Issues in the Doha Round

The Struggle for Legitimacy in the WTO

Debra P. Steger[*]

Introduction

The World Trade Organization (WTO), which was established in 1995, faces two major challenges to its legitimacy and credibility as an international organization.

The first is to make its internal decision-making system more transparent and inclusive, particularly with respect to the developing and least developed countries (which now represent over 100 of its 146 Members). This is the challenge of "internal legitimacy".

The second is to respond to external critics—mainly non-governmental organizations (NGOs) and non-state actors—who maintain that the WTO is a closed, non-democratic, bureaucratic/autocratic supranational entity. This is the issue of "external legitimacy". The external legitimacy challenge arises, in part, because the WTO administers a complex set of agreements that reach deeply into subjects normally assumed to be the province of national and sub-national levels of government—for example, intellectual property, health and safety standards, regulation of services, and subsidies. In addition, the dispute settlement system, with its compulsory jurisdiction and binding decisions, more closely resemble domestic judicial systems than the usual voluntary, international arbitration mechanisms.

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With respect to the issue of internal legitimacy, I shall argue that the difficulty with the decision-making procedures in the WTO do not result from defects in the rules, but rather from the revealed preference of the Members of the WTO to proceed largely by consensus, cumbersome as that might be. Changing the procedures for taking decisions is not likely to change the attitudes of WTO Members. Furthermore, changing the decision-making rules would only exacerbate the problems of internal legitimacy within the WTO, because it would increase the perceptions of developing countries that they are not included in the decision-making processes. However, the WTO has become a very complex enterprise and needs a smaller body than the General Council to address the many administrative, procedural and housekeeping issues that arise, as well as to help set priorities and to help provide direction for the system. In my view, a management board could be made to work in a way that would be inclusive of all WTO Members.

With respect to the issue of external legitimacy, it is the dispute settlement system that has attracted the most attention in the last few years. Whereas the political and legislative bodies of the WTO have been viewed as weak and incapable of taking decisions, the WTO dispute settlement system is viewed by most delegations and observers as having been extremely effective—some would even say "too strong".[1]

To an important extent, this line of criticism of the WTO is emerging from the United States. There is a growing perception in Washington—especially among lawyers representing U.S. industries in antidumping, countervail and safeguards investigations—that the WTO panels and Appellate Body have been

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[1] European Trade Commissioner, Pascal Lamy, in a speech to the German Council on Foreign Relations in Berlin on November 27th, 2001 (after the Doha Ministerial Meeting) stated that "the WTO is fundamentally a weak institution. ... The WTO has a substantial body of rules, including a very strong (some would say too strong) dispute settlement system, but its rule-making machinery is heavy-handed and indeed sometimes chaotic— decisions reached by consensus, usually only at the intermittent biannual Ministerial meetings." Trade Commissioner Lamy's speech is available at http://europa.eu.int/comm/trade/speeches_articles/ spla86_en.htm.

"overreaching" and legislating in recent cases.[2] It is alleged that panels and the Appellate Body have disregarded the intent of negotiators in the WTO legal texts and have created new rights and obligations based on their own policy objectives. In doing so, it is argued, the dispute settlement bodies "undermine the legitimacy of the WTO's agreements, the WTO and its dispute settlement system, and future negotiations on trade."[3] The imbalance that has emerged between the judicial and legislative branches of the WTO, some have argued, is a "formidable constitutional flaw".[4] It is against this background that the United States together with Chile tabled a proposal in the negotiations on the Dispute Settlement Understanding (DSU) in Geneva aimed at "improving flexibility and Member control in WTO dispute settlement".[5]

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[2] See John Greenwald, "WTO Dispute Settlement: An Exercise in Trade Law Legislation?", James P. Durling, "Deference, by Only When Due: WTO Review of Anti-Dumping Measures", and Richard O. Cunningham and Troy H. Cribb, "A Review of WTO Dispute Settlement of US Anti-Dumping and Countervailing Duty Measures", in Vol. 6, No. 1, Journal of International Economic Law 113, 125, 155 (March 2003). See also Paul C. Rosenthal and Jeffrey S. Beckington, "Dispute Settlement Before the World Trade Organization in Antidumping, Countervailing and Safeguard Actions: Effective Interpretation or Unauthorized Legislation?", speech delivered at a conference presented by the Trade and Customs Law Committee of the International Bar Association, "Developments in WTO Law", Geneva, Switzerland, March 20-21, 2003.

[3] Paul C. Rosenthal and Jeffrey S. Beckington, "Dispute Settlement Before the World Trade Organization in Antidumping, Countervailing and Safeguard Actions: Effective Interpretation or Unauthorized Legislation?", speech delivered at a conference presented by the Trade and Customs Law Committee of the International Bar Association, "Developments in WTO Law", Geneva, Switzerland, March 20 & 21, 2003, pg 1.

[4] Claude E. Barfield, *Free Trade, Sovereignty, Democracy: The Future of the World Trade Organization*, The AEI Press, 2001, pg 1.

[5] Contribution by Chile and the United States, "Negotiations on Improvements and Clarifications of the Dispute Settlement Understanding on Improving Flexibility and Member Control in WTO Dispute Settlement", WTO Doc. TN/DS/W/52, March 14th 2003. Ironically, in the Uruguay Round, it was the European Communities who called for greater "flexibility and Member control" in WTO dispute settlement while the United States

Is the WTO constitutionally flawed? Have the judicial bodies exceeded their authority under the WTO Agreement and "legislated", thereby creating new rights and obligations for Members and, by the same token, threatening its legitimacy? I will argue that panels and the Appellate Body have not been "legislating" contrary to the intent of negotiators, but rather have been "clarifying" the existing provisions of the WTO Agreement in accordance with the customary rules of interpretation of public international law as they are required to do.[6] In other words, they have simply been doing their jobs as any international or domestic judicial body would do.

WTO dispute settlement has two tracks, diplomatic and judicial. The diplomatic track includes consultation, mediation, conciliation and arbitration mechanisms, including the good offices of the Director-General. A significant percentage of WTO cases settle early in this diplomatic phase.[7] When a case is referred to a panel, it moves into the judicial track.[8]

The current panel and Appellate Body process in the WTO is thus a hybrid between the "diplomatic" and the "judicial" models. Rather than injecting more "flexibility and Member

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favoured a judicialized system with short timeframes, compulsory jurisdiction, binding rulings and "automatic" recourse to retaliation for non-compliance. In the Doha Round, the tables have turned, with the European Communities proposing further professionalization of the system by creating a permanent standing panel body while the United States advocates more "flexibility and Member control".

[6] Under Article 3.2 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU") and Article 17.6 of the *Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994* (the "*Antidumping Agreement*").

[7] Marc L. Busch and Eric Reinhardt, "The Evolution of GATT/WTO Dispute Settlement", Chapter 5 in this volume, pg 143.

[8] Interestingly, Busch and Reinhardt maintain that, after a panel has been established and a case has moved into the formal judicial process, the chances for settlement are greatly diminished. This is not surprising. In fact, it demonstrates that the parties realize that, at that point, they have entrusted the dispute to an independent, impartial tribunal to be determined on the basis of the law. *Ibid.*

control" into the panel and Appellate Body processes as some have proposed, the legitimacy challenges facing the WTO would best be met by improving the diplomatic process while at the same time taking measures to further "judicialize" or "professionalize" the panel system, improve the rules and procedures for compliance with WTO rulings, and enhance transparency and understanding of the system by opening up panel and Appellate Body hearings to the public.

The following section discusses the issue of legitimacy in conceptual terms. Subsequently, the issues of legitimacy raised by the functioning of the dispute settlement mechanism and of the WTO's rule-making institutions are addressed in turn. The final section draws some conclusions.

What is "Legitimacy"?

The issue of legitimacy is, as noted by J.H.H. Weiler, an inveterate observer of the evolution of the European Community, "part of the standard vocabulary of court watching".[9] In the last few years, it has also become a hot topic for WTO watchers. Although many commentators have written about the so-called "crisis of legitimacy" in the WTO, few have defined the term with any precision.[10]

Robert Keohane and Joseph Nye Jr. equate "legitimacy" with notions of democracy and accountability. They state that

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[9] J.H.H. Weiler, "The Rule of Lawyers and the Ethos of Diplomats: Reflections on the Internal and External Legitimacy of WTO Dispute Settlement", 35(2) Journal of World Trade 2001, 191-207, 193.

[10] See Robert Howse and Kalypso Nicolaidis, "Legitimacy and Global Governance: Why Constitutionalizing the WTO is a Step Too Far" (with Comments by Steve Charnovitz and Gary N. Horlick); Robert O. Keohane and Joseph S. Nye Jr., "The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy" (with Comments by Robert E. Hudec and Daniel C. Esty); and Frieder Roessler, "Are the Judicial Organs of the WTO Overburdened?" (with Comments by William J. Davey), in R.B. Porter, P. Sauve, A. Subramanian, A.B. Zampetti (eds.), *Efficiency, Equity, Legitimacy: The Multilateral Trading System at the Millenium*, Brookings, 2001, 227-333.

"in the contemporary world, democratic norms are increasingly applied to international institutions as a test of their legitimacy." Democratic governments, they maintain, "are judged both on the procedures they follow (inputs) and on the results they obtain (outputs)."[11] With respect to inputs, they argue that the key issues are accountability and the transparency of decision-making procedures. The legitimacy of international organizations, as of governments, also depends upon substantive outputs—that is, on their effectiveness. Although Keohane and Nye recognize that domestic (or even EU) models of democracy do not apply to international organizations (in particular, because there is neither a coherent world polity nor are there institutional arrangements linking the public to those governing these organizations), they recommend that formal political channels be established between international organizations and constituencies within civil society.[12]

Any examination of the legitimacy of an institution, therefore, must be based on both inputs and outputs. On the input side, the institution must be accountable to its constituencies (however defined) and transparent. On the output side, the institution must be effective. Furthermore, because the *perceptions* of constituents and observers can be more important than the objective realities, the institution must also be *perceived* to be effective.

Robert E. Hudec, a renowned legal scholar on the GATT and WTO, has questioned whether the WTO *is* an institution of governance, separate from the governments which comprise it.[13] He maintains that the WTO is, first and foremost, an international organization and, as such, definitions of legitimacy applied to it cannot be the same as definitions applied to national governments. Grounding discussions of legitimacy in relation to the WTO in notions of democracy, therefore, is fundamentally flawed.

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[11] Keohane and Nye, *supra*, note 10, page 281-282.

[12] *Ibid.*, 290-291.

[13] Comment by Robert E. Hudec, in Porter, Sauve, Subramanian and Zampetti, *Efficiency, Equity, Legitimacy: The Multilateral Trading System at the Millenium*, *supra*, note 10, 295-300, 298.

Taking Professor Hudec's sage advice, we see that, first and foremost, the WTO is an *intergovernmental* organization comprised of 146 member governments. Most decisions of its political/legislative bodies (i.e., the Ministerial Council, the General Council, other Councils, and Committees) are taken by consensus, although in certain cases the WTO Agreement provides for simple majority voting and in other cases for decisions to be taken by a two-thirds or three-fourths majority. The WTO Agreement itself also constitutes a system of law—for legal purists, an international system of rules—enforced through an automatic and binding dispute settlement system.

Thomas M. Franck, in his book, *The Power of Legitimacy Among Nations*, searches for the properties of "legitimacy" as it applies to international systems of rules.[14] He defines "legitimacy" in this context as: *"a property of a rule or rule-making institution which itself exerts a pull toward compliance on those addressed normatively*[15] *because those addressed believe that the rule or institution has come into being and operates in accordance with generally accepted principles of right process."*[16] Legitimacy theory, he acknowledges, "has many mansions. If this be muddle, it is muddle of a very high order…."[17] In his search for a taxonomy of the properties of legitimacy, Franck poses the question: "Why do nations obey rules?" And, he proposes the following hypothetical answer to this question: "Because they perceive the rule and its institutional penumbra to have a high degree of legitimacy."[18]

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[14] Thomas M. Franck, *The Power of Legitimacy Among Nations*, Oxford University Press, 1990. For an excellent review of Franck's seminal work, see Jose E. Alvarez, "The Quest for Legitimacy: An Examination of the Power of Legitimacy Among Nations" by Thomas M. Franck", 24 *New York University Journal of International Law and Politics* (1991), 199-267.

[15] "Those addressed", Franck states, could include "nations, international organizations, leadership elites, and, on occasion, multinational corporations and the global populace." *Ibid.*, 16.

[16] *Ibid.*, 24.

[17] *Ibid.*, 19.

In developing his hypothesis, Franck defines and examines four indicators of legitimacy applicable in "the community of states": *determinacy, symbolic validation, coherence* and *adherence*. His hypothesis asserts, furthermore, that "to the extent a rule, or rule process, exhibits these four properties it will exert a strong pull on states to comply. To the extent these properties are not present, the institution will be easier to ignore and the rule easier to avoid by a state tempted to pursue its short-term self-interest."[19]

A rule's *determinacy* is defined by its textual "clarity" or "transparency"—"that which makes its message clear".[20] Franck recognizes, however, that the degree of clarity of a rule may reflect the degree of agreement among its negotiators. Even textually vague or opaque rules may be made determinant, he states, by a clarification process which itself is perceived as legitimate, such as a court or an international dispute settlement process.[21]

Symbolic validation represents the cultural and anthropological dimension of legitimacy that communicates the "validity" or the "authenticity" of a rule or a rule-making institution. "Ritual" and "pedigree" are forms of symbolic validation, which is part of the legitimation strategy of all communities, or rules-based systems.[22]

Coherence, which Franck notes, is different from "consistency"[23], relates to a rule's "connectedness" or "nexus" to rational principles of general application. "Coherence legitimates a rule, principle, or implementing institution because it provides a reasonable connection between a rule, or the application of a rule, to 1) its own principled purpose, 2) principles previously employed to solve similar problems, and 3) a lattice of principles in use to resolve different problems."[24] Coherence applies both "internally (among the several parts and purposes of the rule) and externally (between one rule and other rules, through shared principles)."[25] In examining coherence and its effect on the perception of a system's legitimacy, Franck assumes that there exists a "community" of nations with a "*system* of principles, rules, and decision-making processes."[26]

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[18] *Ibid.*, 25.

[19] *Ibid.*, 49.

[20] *Ibid.*, 52.

[21] *Ibid.*, 50-66.

[22] *Ibid.*, 96.

[23] Franck states that "consistency requires that 'likes be treated alike' while coherence requires that distinctions in the treatment of 'likes' be *justifiable in principled terms*. ... Coherence demands a different level of con-

Finally, *adherence* is what turns an international community into a *system of rules*. By "adherence", Franck means "the vertical nexus between a primary rule of obligation ... and a hierarchy of secondary rules identifying the sources of rules and establishing normative standards that define how rules are to be made, interpreted, and applied."[27] Primary rules, that represent merely *ad hoc* arrangements between parties, will not exert a "pull toward compliance" unless they are reinforced "by a hierarchy of secondary rules which define the rule-system's 'right process'." Rather, "a rule is more likely to obligate if it is made within the framework of an organized normative hierarchy, than if it is merely an *ad hoc* agreement between parties in a state of nature."[28]

Franck's indicators of determinacy, symbolic validation, coherence and adherence provide a framework for assessing the "legitimacy" of the WTO as an international system of rules.

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nectedness between instances covered by a rule than does consistency." *Ibid*., 144.

[24] *Ibid*., 147-48.

[25] *Ibid*., 180.

[26] *Ibid*., 181. Emphasis added.

[27] *Ibid*., 184.

[28] *Ibid*.

For example, we can assess the extent to which the WTO legal system exerts a "compliance pull" on its Member states. We can examine the inputs into the WTO rule-making and dispute settlement processes to assess whether due process and fairness (i.e., "right process") are applied in making and interpreting the rules. And we can analyze the outputs of the system, by assessing the quality and coherence of the dispute settlement decisions interpreting the rules.

Against this background, this chapter discusses the functioning of the dispute settlement system, which has pulls both toward diplomacy and judicialization, and of the WTO's rule-making institutions—its political/legislative bodies—to assess whether they are effective in contributing to the legitimacy of the WTO as an international system of rules.

The Dispute Settlement System

The "Diplomatic" vs. The "Judicial" Model

There has long been a tension between the "diplomatic" and the "judicial" features of GATT/WTO dispute settlement.[29] Even during the GATT era, multilateral dispute settlement was evolving ever more towards a judicialized model. For example, in 1989, improvements to the dispute settlement process agreed at the Montreal Ministerial Meeting of 1988 enabled panels to be automatically established upon the request of a complaining party.[30] Under the previous GATT system, a consensus decision of the GATT CONTRACTING PARTIES had been required to establish a panel, and, thus, to initiate proceedings. Pursuant to the 1989 *Improvements*, panels were also given standard terms of reference, a change from the previous practice of the parties determining the terms of reference through negotiation.

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[29] I have previously referred to this as a "balance" between the pragmatic and the legalistic, but if it is a balance, it is a delicate one. Debra P. Steger and Susan M. Hainsworth, "World Trade Organization Dispute Settlement: The First Three Years", 1:2 Journal of International Economic Law 199 (June 1998); See also Robert E. Hudec, *Enforcing International Trade Law: The Evolution of the Modern GATT Legal System*, Butterworths, 1993, 11-15; J.H. Jackson, *Restructuring the GATT System*, Royal Institute of International Affairs, 1990, 59-68.

[30] See "1989 Improvements to GATT Dispute Settlement Rules and Procedures" at http://www.worldtradelaw.net/misc/disputetexts.htm

The reforms to the DSU agreed in the Uruguay Round, which *inter alia* provided for binding decisions and established the Appellate Body, accelerated this trend. In fact, Professor Weiler has characterized these modifications as representing a "paradigm shift" toward the "juridification" of the WTO.[31]

A major problem in the GATT system had been that reports or decisions of panels had to be adopted by a consensus decision of the CONTRACTING PARTIES in order to become legally effective. However, a party could (and sometimes, did) "block" the adoption of a panel report. The DSU reforms addressed this problem by providing that the reports or decisions of panels and the Appellate Body were to be automatically "adopted" by the Dispute Settlement Body (DSB), a political body made up of all WTO Members, unless there were "reverse consensus" decisions against adoption. Reports of panels and the Appellate Body become legally effective upon their adoption by the DSB. Decisions of the DSB to authorize retaliation (i.e., suspension of concessions) for failure to implement the rulings of a panel or the Appellate Body were also to be taken "automatically", meaning that once a party to the dispute had formally requested authorization to retaliate, if all the legal requirements had been met, the DSB would have been bound to take that decision, unless there were "reverse consensus" decisions.

The establishment of the Appellate Body, a standing tribunal devoted to hearing appeals on questions of law and legal interpretation from panel reports, was intended by Uruguay Round negotiators as part of the *quid pro quo* for automatic adoption of panel reports—in effect, it was to safeguard against the occasional "wrong" decision of panels.[32] The Appellate Body is comprised of seven persons, appointed by consensus by the Members of the WTO, on the basis of their qualifications taking into account the overall geographic representation and diversity of legal systems within the WTO Membership. All but one of the seven incumbents of the Appellate Body are legally-trained jurists; most have distinguished backgrounds in public international law or international economic law generally, rather than in trade policy *per se*. Their qualifications are very similar to those of judges appointed to other international tribunals. The Members of the WTO, whether by deliberate design or by default, have appointed highly respected jurists—with judicial skills and perspectives—to the Appellate Body.

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[31] J.H.H. Weiler, note 9, at 192; See also Ari Reich, "From Diplomacy to Law: The Juridicization of International Trade Relations", 17 *Northwestern Journal of International Law & Business* 775 (1996-1997).

The DSU reforms, especially the establishment of the Appellate Body, have driven the system more dynamically toward a "judicialized" model, but elements of the "diplomatic" model remain. These diplomatic elements make the dispute settlement system more acceptable to the delegations of WTO Member governments in Geneva, and thus contribute to its "internal" legitimacy. However, these same diplomatic elements raise questions of accountability and reduce the transparency of the WTO dispute settlement system to the outside world—in other words, they detract from its "external" legitimacy.

There is a struggle over legitimacy within the WTO, and the dispute settlement system has become the battleground. There are conflicting pulls on the system. From *within*, Member governments perceive the dispute settlement system as essentially diplomatic and want to keep it that way so as to enhance their "control" over it. From *outside*, NGOs and representatives of civil society maintain that the system must become more open and transparent, and must provide greater access to WTO processes—e.g., through *amicus curiae* briefs—as well as access to the information prerequisite for informed participation, not only for Members of the WTO but also for non-state "stakeholders".[33]

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[32] Debra P. Steger, "The Appellate Body and its Contribution to WTO Dispute Settlement", in D. Kennedy and J. Southwick (eds.), *The Political Economy of International Trade Law: Essays in Honour of Robert E. Hudec*, Cambridge University Press, 2002, 482-495, at 483.

The "Diplomatic" Vestiges Remaining in the Panel System

Several vestiges of the "diplomatic" model of dispute settlement remain in the panel system in the WTO. They endure because most WTO Members put a high priority on retaining control and authority over the system (both in terms of inputs and outputs).[34] Two of the most important diplomatic features are the selection and *modus operandi* of panels and the confidentiality or secrecy of dispute settlement proceedings.

Panels are selected by the agreement of the parties to the dispute, based on nominations made by the WTO Secretariat, and can be composed of government officials or non-governmental individuals.[35] The overwhelming majority of panelists selected to serve since 1995 have been government officials, often working with delegations in Geneva. When the parties cannot agree on the three persons to sit on a panel, the Director-General of the WTO may appoint the panel.[36] This is occurring in an increasing number of cases, because the parties cannot always agree on the composition of panels.

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[33] For an excellent debate on who are the "stakeholders" in the WTO, and who should have standing in WTO dispute settlement, see: Philip M. Nichols, "Extension of Standing in the World Trade Organization", 17 *University of Pennsylvania Journal of International Economic Law* 310 (1996); Richard Shell, "The Trade Stakeholders Model and Participation by Nonstate Parties in the World Trade Organization", 17 *University of Pennsylvania Journal of International Economic Law* 370 (1996); Steve Charnovitz, "Participation of Nongovernmental Organizations in the World Trade Organization", 17 *University of Pennsylvania Journal of International Economic Law* 339 (1996); Philip M. Nichols, "Realism, Liberalism, Values, and the World Trade Organization", 17 *University of Pennsylvania Journal of International Economic Law* 859 (1996).

[34] The recent proposal by Chile and the United States in the Doha Round DSU negotiations underlines this desire to "control" even the judicial aspects of the dispute settlement system. See note 5 herein.

[35] DSU, Article 8.

[36] DSU, Article 8.7.

The function of panels, as set forth in Article 11 of the DSU, illustrates the tension between the "judicial" and "diplomatic" approaches. On the one hand Article 11 requires a panel to "make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements". On the other hand, this same Article states that panels "should consult regularly with the parties to the dispute and give them adequate opportunity to develop a mutually satisfactory solution."[37] In order to assist them in carrying out their functions, panels are provided with a sparse set of working procedures in an appendix to the DSU, and are instructed that they may devise additional procedures which "provide sufficient flexibility as to ensure high-quality panel reports, while not unduly delaying the panel process."[38] While the DSU provides only that a panel must "consult" with the parties to the dispute when it wishes to adopt additional procedures, panels have been reluctant, on their own, to adopt procedures without the agreement of the parties. This has led the WTO Secretariat to develop a model set of working procedures, which most panels now adopt. However, these procedures deal mostly with issues such as timeframes for filing submissions, holding meetings and responding to questions. They do not deal with the more difficult and contentious issues, such as admissibility of *amicus curiae* briefs.

Panels are assisted in their deliberations by legal officers of the WTO Secretariat. Because the government officials who sit on panels tend not to be legally trained and often have little time for their panel work, the legal officers assigned to the panel at times take a lead role in assessing the facts, analyzing the legal issues and drafting the panel's decision. The parties are given an opportunity to review the panel's decision before it is circulated, and may submit comments to the panel for consideration in finalizing its report. Although the interim review process has rarely led to a panel changing its conclusions or its legal reasoning, it has led, in certain cases, to some important clarifications being made.

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[37] DSU, Article 11.

[38] DSU, Article 12.2.

The continuing selection of panelists on an *ad hoc* basis from the pool of Geneva-based government officials contributes to the "internal" legitimacy of the dispute settlement system because it gives WTO Member governments at least the perception of control over panel proceedings. Parties to the dispute can select those whom they want to sit on a particular case (more particularly, they can reject suggestions made by the Secretariat even for reasons as specious as the continent from which the person originates). The parties can determine the panel's procedures. They can present the facts as they see them, and they are given an opportunity to comment on the panel's description and assessment of the facts (parties are often very particular about how their arguments and evidence are presented in the descriptive parts of panel reports). And, finally, the parties can comment on a panel's conclusions and legal reasoning even before the final panel report has been circulated and made public.

The *ad hoc* nature of the panel system, the background and qualifications of persons typically appointed as panelists, the lack of consistency and coherence in panel procedures from case to case, and the inconsistency in the quality of the legal reasoning of panels, all contributes to a perception by the outside world of a closed system run by bureaucrats and government trade policy officials, so-called "insiders". There is some accuracy to that perception of the panel system. Each panel is appointed to hear a particular case, and works in isolation from other panels, without the requirement to observe specific rules of procedure or rules of evidence. The only unifying institutional influence is that of the WTO Secretariat officials—legal officers and panel secretaries assigned to work on the case (although not all the legal officers who work with panels are in the Legal Affairs Division; they are drawn from different divisions within the Secretariat).

Thus, within the panel system, there are weak institutional mechanisms for ensuring coherence and consistency. This militates against common approaches to issues of natural justice, fairness and due process. Moreover, since panelists are appointed solely to hear the case before them, they do not typically take a long-term institutional view of the practices and procedures they are developing, or of the substantive issues of interpretation they may confront, because their goal is simply to assist the parties to that dispute to come to a mutual resolution of that case.

Confidentiality or secrecy is a hallmark of WTO dispute settlement which is explicitly mandated in the DSU: panel deliberations, Appellate Body proceedings, submissions of parties and third parties to a dispute, as well as information provided to a panel by outside individuals or bodies are required to be kept confidential.[39] This emphasis on confidentiality is a vestige of "diplomatic" dispute settlement. Governments have traditionally maintained that keeping proceedings confidential provides them the flexibility to resolve disputes through negotiation. It is true, keeping submissions and proceedings confidential does give the governmental parties to a dispute a privileged position of being the only ones who know what a case is about and thus greater room to manoeuvre in reaching settlements.

At the same time, however, there are important counter arguments. Under the GATT, there was a perception within the system that disputes were of interest only to the parties to the dispute and that panel rulings applied only narrowly to those parties. However, it is clear that this perception has changed within the context of the WTO. In an overwhelming majority of disputes under the WTO to date, there has been a high degree of third party participation by other Members of the WTO. Often Members who notify their interests as third parties to the DSB do not have trade interests at stake, but rather openly state that their interest is "systemic" in nature. Also, it has become commonplace in DSB meetings for Members of the WTO which are not directly involved in a particular dispute, either as parties to the dispute or as third parties, to express views on issues of systemic interest raised by the case.

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[39] DSU, Articles 13.1, 14.1, 17.10, 18.2 and Appendix 3, para. 3.

Although many Members of the WTO, particularly the developing countries, remain deeply committed to the principles of confidentiality in dispute settlement, the current rules work against the interests of Members of the WTO who are not parties or third parties to a dispute but who may face similar legal issues arising in other disputes or who take an interest in possible systemic implications.

In my view, the rules requiring confidentiality of documents and proceedings undermine the internal legitimacy of the dispute settlement system because they deny other WTO Member governments the opportunity to know what is being argued in particular cases. Furthermore, within civil society, these rules breed distrust and misunderstanding of the dispute settlement system. Nothing works against the external legitimacy of the WTO dispute system as powerfully as its lack of transparency and the secrecy within which panels and the Appellate Body are required to operate under the DSU. Opening the system up would not only eradicate the perceptions of a non-transparent process lacking in due process and fairness guarantees, but would also improve public understanding of the system.

The "Judicial" Features

The combined effect of introducing compulsory adjudication, automatic adoption of panel and Appellate Body reports, and automatic authorization of retaliation in cases of noncompliance has been to give the dispute settlement process some degree of predictability and to make the findings and conclusions of panels legally binding and effectively enforceable.

Some commentators, however, have argued that the DSU reforms have given an inordinate amount of power to the "judicial" branch of the WTO, resulting in an imbalance of power vis-à-vis the "legislative" branch.[40] For example, decisions of panels and the Appellate Body are adopted automatically by the DSB, yet the WTO legislative body (the General Council) can only remedy DSB rulings by making decisions pursuant to the procedures for making interpretations or amendments under Articles IX or X of the *Marrakesh Agreement Establishing the World Trade Organization*.

In the view of some critics, this imbalance represents a fundamental "constitutional defect",[41] prompting suggestions that the "automaticity" in adoption of panel and Appellate Body reports be undone, so that legal findings and conclusions of a panel or the Appellate Body could be rejected by a vote of one-third of WTO Members.[42]

Some critics maintain that the Appellate Body has "over-reached" its constitutional authority under the DSU in several cases, arguing that its decisions have filled gaps in the legal framework left by the political bodies of the WTO. The result, pursuant to this argument, is that the Appellate Body is "legislating" and thereby modifying the rights and obligations of Members as negotiated under the WTO Agreement.

Are these commentators correct? Has the Appellate Body exceeded its authority and created difficulties for the internal legitimacy of the WTO dispute settlement system? Has it contributed to, or detracted from, the external legitimacy of the WTO dispute settlement system?

To get at these questions we turn to Franck's indicators of legitimacy, taking as our starting point the stated purpose of the WTO dispute settlement system:

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[40] See Frieder Roessler, "Are the Judicial Organs of the World Trade Organization Overburdened?", in Porter, Sauve, Subramanian, & Zampetti (eds.), *Efficiency, Equity, Legitimacy: The Multilateral Trading System at the Millenium*, Brookings, 2001, 308-328; Frieder Roessler, "The Institutional Balance Between the Judicial and the Political Organs of the WTO", in M. Bronckers and R. Quick (eds.), *New Directions in International Economic Law: Essays in Honour of John H. Jackson*, Kluwer, 2000, 325-345.

[41] Claude E. Barfield, note 4, at page 7.

[42] *Ibid.*, at 127.

> The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system. The Members recognize that it serves *to preserve the rights and obligations of Members* under the covered agreements, and *to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law.* Recommendations and rulings of the DSB *cannot add to or diminish the rights and obligations* provided in the covered agreements.[43]

With respect to Franck's first indicator, "determinacy", not all WTO rules are models of textual clarity. Indeed, some of the language in the 500 or so pages of the text of the WTO Agreement is deliberately vague, reflecting a lack of agreement among the negotiators. That being said, one of the purposes of dispute settlement as stated in Article 3.2 of the DSU, quoted above, is precisely "to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law." As Franck notes, it is common for treaties, and even constitutions, to contain rules that have a certain degree of ambiguity because of unresolved disagreements or uncertainties.[44] Such vagueness is not necessarily a problem; it may leave room for a rule to evolve flexibly through interpretation and application by a process of clarification recognized as legitimate by those to whom the rules are addressed.[45] Franck suggests that courts are a credible process of clarification, but not the only such process. Whether a "clarifying process" is successful in transforming an "indeterminate" rule into a "determinate" rule, depends upon such factors of legitimacy "*as who* is doing the interpreting, their *pedigree* or authority to interpret, and the *coherence* of the principles the interpreters apply."[46]

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[43] DSU, Article 3.2. Emphasis added.

[44] Franck, note 14, at 53.

[45] *Ibid.*, at 61.

[46] *Ibid.*

The Appellate Body, in its very first case, *United States — Standards for Reformulated and Conventional Gasoline*, set forth the interpretative approach that it was to follow in subsequent cases. In that case, the Appellate Body stated that the "general rule of interpretation" set forth in Article 31 of the Vienna Convention on the Law of Treaties is a rule of customary international law that is to be followed in interpreting and applying provisions of the WTO Agreement. Article 3.2 of the DSU, the Appellate Body noted, recognizes that the WTO rules are "not to be read in clinical isolation from public international law."[47]

Rather than "legislating" to fill in gaps in the WTO's legal framework, the Appellate Body has consistently applied an internationally agreed set of rules to interpret the provisions of the WTO Agreement. In so doing, it has developed a coherent approach to interpretation, in accordance with accepted principles of international law, and has required that panels follow the same method. Thus, the Appellate Body has adopted a "right process" for interpreting and clarifying the sometimes "indeterminate" rules in the WTO Agreement.

With respect to the factor of "symbolic validation", which features of the WTO's judicial bodies might be said to correspond to Franck's concepts of "rituals" and "pedigree"?

In relation to "pedigree", the Appellate Body is a relatively new judicial institution and was not created endowed with an established reputation. It has had to develop, through its first cases, its own credibility and legitimacy as an international tribunal. The Members of the WTO, in retrospect, made very wise decisions in selecting who would be the first seven Members of the Appellate Body. After interviewing 32 candidates nominated by Members of the WTO, the DSB, after a long, difficult process, finally selected the original seven members of the Appellate Body. As Franck has observed, *who* decides is an important factor in the legitimacy of a clarifying judicial process or institution. The original seven members of the Appellate Body were all highly respected jurists with impeccable credentials—senior judges, lawyers and law professors, with extensive backgrounds in public international law or international economic law generally—the very type of persons who would be appointed to the International Court of Justice or other international tribunals. Notably, they were not, for the most part, government trade policy officials. In the more recent appointments made in 2000 and 2001, the DSB has followed the same pattern, selecting senior jurists, law professors and judges with backgrounds in public international law, rather than trade policy practitioners. There is no doubt that the selection of this type of person has made a major difference in the style and content of judicial decisions.

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[47] Report of the Appellate Body, *United States — Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, adopted May 20th, 1996, pg 17.

Scanning for "rituals", one might examine the procedures adopted by the WTO's judicial bodies. Before the first appeal was filed, the members of the Appellate Body developed and adopted their own detailed rules of procedure, dealing with internal matters relating to the functioning of the Appellate Body as well as the appellate review process. Among its working procedures, the Appellate Body required "collegiality" in its decision-making. This meant that, although the three persons selected to hear a particular appeal would be responsible for deciding that case, all seven members of the Appellate Body would convene in Geneva to discuss and provide guidance on each case. This principle of "collegiality", which has been applied religiously by the Appellate Body in practice, has done much to ensure coherence and consistency of its decisions and rulings on issues of legal interpretation as well as on matters relating to practice and procedure.

Another "ritual" that has helped to establish the Appellate Body as a respected, judicial institution is the swearing in ceremony for new members. The first such ceremony, held in 1995, was a small, closed affair, attended by the Director-General, his Deputies, the Chairs of the General Council, the DSB, and the Councils for Trade in Goods, Trade in Services and Trade-related Intellectual Property, members of the Appellate Body and their staff. The second such ceremony was conducted in a similar manner, with only the Chairs of the General Council, the DSB, and the Councils for Trade in Goods, Trade in Services and Trade-related Property representing the WTO Membership; however, a large reception was held after the ceremony to which the general WTO Membership was invited. In 2001, the ceremony swearing in three new members and bidding farewell to three retiring members was held in a formal meeting of the General Council, with all of the WTO Membership in attendance. The progressive development of this ritual indicates recognition of the growing respect and esteem held by WTO Members for the institution of the Appellate Body.

Another very important "ritual"-like feature of the Appellate Body is the way that it conducts its hearings in individual appeals. Unlike panel meetings with the parties, Appellate Body hearings are conducted in a very judicial manner. After the parties and third parties have made their opening arguments (they are given time limits for their presentations), the members of the Appellate Body hearing the appeal engage in intensive, detailed questioning of the parties and third parties until all the legal issues in the case have been thoroughly examined. While this is often grueling for the parties' counsel, this "face-to-face" interrogation on the issues of law in the case is critical to the Appellate Body's understanding and appreciation of the appeal. From a Franckian perspective, this procedure, which has been developed by the Appellate Body in practice, has a ritualistic quality that has worked to establish the credibility and reputation of the Appellate Body as an impartial and independent judicial institution.[48]

With respect to the factor of "coherence", in its early jurisprudence, the Appellate Body has established a rigorous approach to treaty interpretation, based on the general principles of interpretation set forth in the Vienna Convention as required by Article 3.2 of the DSU. It also has drawn guidance from time to time, where appropriate, from the practice of other international tribunals and public international law generally. Moreover, the Appellate Body has developed a comprehensive set of rulings on matters of judicial practice and procedure, dealing with such issues as standing, burden of proof, treatment of evidence and experts, standard of review, jurisdiction of panels, rights of third parties, right to be represented by counsel and treatment of *amicus curiae* briefs.

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[48] One Ambassador for a third party in the *EC-Bananas* case, took the opportunity to comment to the Appellate Body Division hearing that case that he wished the rest of the WTO worked as effectively and efficiently as the Appellate Body in that hearing.

In making some of its procedural rulings, particularly with respect to the right to representation by private counsel and the acceptance and consideration of *amicus* briefs, the Appellate Body has come under criticism by many WTO Members and some commentators, who maintain that these procedural gaps in the DSU can only be filled by the Members of the WTO, acting in their legislative capacity, and not by the "judicial" bodies of the WTO through the development of case law.[49] Whether or not they agree with individual rulings of the Appellate Body on these matters, legal scholars generally concur that the Appellate Body has behaved, in general, like a prudent, conservative court, motivated by general principles of natural justice, due process and fairness, taking pains to demonstrate its motivations and legal reasoning in its published decisions.[50] In its rulings to date, the Appellate Body has established a comprehensive jurisprudence on matters of judicial practice and procedure applicable not only to its own proceedings but also to the proceedings of panels.

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[49] Barfield, note 4, 50-53.

[50] See: William J. Davey, "Has the WTO Dispute Settlement System Exceeded Its Authority?", in Thomas Cottier and Petros Mavroidis (eds.), *The Role of the Judge: Lessons for the WTO*, Kluwer forthcoming, 2002; Robert Howse, "The Most Dangerous Branch? WTO Appellate Body Jurisprudence, on the Nature and Limits of the Judicial Power, in Thomas Cottier and Petros Mavroidis (eds.), *The Role of the Judge: Lessons for the WTO*, Kluwer forthcoming, 2002; Robert Howse, "Adjudicative Legitimacy and Treaty Interpretation in International Trade Law: The Early Years of WTO Jurisprudence", in J.H.H. Weiler (ed.), *The EU; the WTO and the NAFTA: Towards a Common Law of International Trade*, Oxford University Press, 2000, 35; John H. Jackson, "Dispute Settlement and the WTO: Emerging Problems", 1 *Journal of International Economic Law* 329 (1998); Robert E. Hudec, "The New WTO Dispute Settlement Procedure: An Overview of the First Three Years", 8 *Minnesota Journal of Global Trade* 1 (1999); J.H.H. Weiler, "The Rule of Lawyers and the Ethos of Diplomats: Reflections on WTO Dispute Settlement", in Porter, Sauve, Subramanian & Zampetti (eds.),

On the issue of "adherence", Professor Franck tells us: "A rule has greater legitimacy if it is validated by having been made in accordance with secondary rules about rule-making."[51] Although it is still early days in the history of the WTO dispute settlement system, there are some discernible trends beginning to emerge. In my observations above relating to the factor of "coherence", I stated that the Appellate Body had developed a comprehensive and impressive set of rulings on practice and procedure in the appeals it has heard to date. These rulings together with the many interpretative rulings made by the Appellate Body weave together to make a fabric of secondary rules which help to build the foundation of a legitimate judicial institution out of the dispute settlement system of the WTO. This jurisprudence creates a permanent foundation, based on principles of natural justice, due process and fairness—a "right process"—for the WTO dispute settlement system.

The Rule-Making Institutions

While the Appellate Body has been working strategically and purposefully toward establishing its credibility and legitimacy as an international tribunal, the same cannot be said of the WTO political/legislative bodies. The latter WTO bodies have been characterized as "weak" by the key powers in the multilateral trading system.[52] European trade lawyer and scholar, Marco Bronckers, has stated that under the new WTO procedures for adopting definitive interpretations or amending provisions of

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Efficiency, Equity, Legitimacy: The Multilateral Trading System at the Millenium, Brookings, 2001, 334, 346.

[51] Franck, note 14, at 193.

[52] See the speech by Pascal Lamy, European Trade Commissioner, referred to in note 1 herein.

the agreements: "Clarifying rules is practically impossible" and "[a]dopting new rules is cumbersome".[53] "The bottom line," asserts Claude Barfield, "given the extreme difficulty of using normal legislative procedures in the WTO, is that dispute settlement panels and the Appellate Body will be under increasing pressure to legislate through interpretation and filling in the blanks in WTO disciplines."[54]

The administrative structure and the decision-making apparatus of the WTO *is* complex.[55] The general rule on decision-making is that the WTO will "continue the *practice* of decision-making by consensus followed under GATT 1947."[56] Where certain decisions cannot be arrived at by consensus,[57] the *Mar-*

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[53] Marco C.E.J. Bronckers, "Better Rules for a New Millenium: A Warning Against Undemocratic Developments in the WTO", 2:4 *Journal of International Economic Law* 547, 551-552 (December 1999).

[54] Barfield, note 4, 42.

[55] These organizational features of the WTO are set forth in the *Marrakesh Agreement*, which is a sort of "mini-constitution" for the multilateral trading system. The *Marrakesh Agreement* was negotiated during the latter part of the Uruguay Round in the Institutions Group, chaired by Ambassador Julio Lacarte-Muro from Uruguay (who was the first Chairman of the Appellate Body). The history of this negotiation and the decision-making provisions of this agreement are described in Debra P. Steger, "The World Trade Organization: A New Constitution for the Trading System", in M. Bronckers and R. Quick (eds.), *New Directions in International Economic Law*, Kluwer, 2000, 135-153.

[56] *Marrakesh Agreement*, Article IX:1. The term "practice" is used to describe the way decisions were made in the GATT since the 1960s because consensus decision-making was not the rule—the rule under Article XXV of the GATT 1947 was majority voting—rather, it was the "practice". Article IX: I of the *Marrakesh Agreement* enshrined this "practice" and made it the "rule" for the WTO. Emphasis added.

[57] "Consensus" does not mean "unanimity". A decision is "deemed" to have been decided by consensus "if no Member, present at the meeting when the decision is taken, formally objects to the proposed decision." *Marrakesh Agreement*, Article IX: 1, footnote 1. The Rules of Procedure of the General Council (the highest political/legislative body in the WTO when the Ministerial Conference is not in session) and the other Councils require that a quorum of two-thirds of the Members be present at any formal meeting; however, that does not always happen. Technically, therefore, a decision could

rakesh Agreement provides for a fallback to majority voting. However, for important decisions, such as adoption of a definitive interpretation of an agreement or approval of a waiver from obligations, the Ministerial Conference or the General Council shall first attempt to take the decision by consensus, and if this fails, the decision may be taken by a three-fourths majority of all the Members of the WTO.[58] Decisions to propose amendments to the agreements must be initially attempted to be made by consensus. If, after 90 days, consensus has not been reached, the Ministerial Conference may take the decision by a two-thirds majority of the Members.[59] For most amendments, a decision by the Ministerial Conference to propose an amendment to the Members is only the first step. Following this decision, Members of the WTO must individually ratify and accept the amendment or the proposal for a new rule or agreement. Amendments will only take effect when they have been accepted by two-thirds of the Members of the WTO (for most agreements).[60] Amendments of the DSU are effective upon a consensus decision of the Ministerial Conference approving the proposal to amend the agreement. It is not necessary for individual WTO Members to ratify and accept amendments to the DSU, such amendments become effective upon the consensus decision of the Ministerial Conference approving the amendment.[61]

On the face of it, the commentators are right—the WTO decision-making procedures *are* cumbersome and difficult. Here lies the paradox: the procedures are cumbersome because they are designed to be inclusive, to ensure that decisions are supported by all Members. However, consensus decision-

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be proposed for approval by consensus at a meeting with 97 Members represented in the room, and that decision would be taken unless one or more Members formally objected to it.

[58] *Marrakesh Agreement*, Article IX, paras. 2 and 3.

[59] *Marrakesh Agreement*, Article X:1.

[60] *Marrakesh Agreement*, Article X, paras. 3, 4 and 5.

[61] *Marrakesh Agreement*, Article X:8.

making also allows one country, no matter what its size or relative power, to prevent a decision from being taken. Thus, individual Members can, and do, "hijack" the system from time to time, not always for rational reasons.

This has led the major powers to use informal techniques of "consensus-building", involving groupings of countries (e.g., such as "Green Room" meetings) which inevitably means that some countries are not included in the key planning and drafting stages of a particular proposed decision. This solution can, however, lead to further problems: for example, at the Seattle Ministerial Meeting in 1999, a large group of developing countries threatened to walk out of the meeting because they claimed they were not included in the "Green Room" meetings in which approximately 60 heads of delegation were involved. Moreover, even when a proposal that has gone through a thorough informal "consensus-building" exercise, it can meet with blocking tactics when a Member attempts to put it on the agenda of a formal meeting for approval.[62]

Is there a "constitutional defect" in the decision-making rules of the WTO? Can they be amended to make them more functional? How can developing countries be made to feel more included in the system?

To be fair, the new rules for making definitive interpretations or amendments of the agreements have not yet been used. However, many important decisions have been taken, including decisions approving the accession of several new Members to the WTO as well as decisions granting waivers from WTO obligations for specific countries. Almost all of these decisions have been taken by consensus in the General Council after careful preparation in informal meetings of working parties open to participation by all WTO Members. In only one case to date, the accession of Ecuador in 1995, was a decision taken by a vote, rather than by consensus.[63] A long struggle occurred in 1999 over the selection of a new Director-General because Membership support was almost evenly divided between two candidates for the post. Eventually, that impasse was resolved when it was decided that the term would be split into two parts, with each candidate taking the post for a period of three years. However, while this issue was being settled, the WTO was nearly paralyzed for several months, which in the view of many contributed to the failure of the Seattle Ministerial Meeting.

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[62] For example, in 1999, before the Seattle Ministerial Meeting, an informal group of approximately 14 countries met outside of the WTO to draft a proposed amendment to the DSU attempting to resolve some of the ambiguities in Articles 21.5 and 22 of that agreement relating to implementation of rulings. The meetings of this informal group were open to any country that wished to participate. Although this group, chaired by Japan, attempted on several occasions to bring its draft amendment into a formal meeting of the DSB, this was blocked repeatedly by two developing country delegations (not because they were not included in the negotiation—they did participate—they blocked for strategic reasons unrelated to the text of the proposed amendment itself).

Amending the decision-making procedures would be extremely difficult, if not impossible. All WTO Members, from the US and EU to the least-developed countries, are wedded to the practice of decision-making by consensus. It is part of the *ethos* of the WTO. It would not be in the interests of developing countries for the WTO to adopt weighted-voting mechanisms such as those used in the International Monetary Fund and the World Bank. The Members of the WTO are strongly opposed to any such suggestion, and such a mechanism would not help to make the WTO more inclusive of developing countries.

One might ask: if it is so difficult to achieve consensus, why do Members not use the voting procedures more often? Although the thresholds for decisions to adopt interpretations, waivers or amendments are very high (three-fourths or two-thirds of the Membership), for many decisions, such as the election of a new Director-General, the "fallback" would be to a simple majority vote. However, although the rules have always provided that decisions could be taken by a majority vote,[64] this has not been the practice in the GATT or in the WTO. Members seem to prefer to use the cumbersome and slow process of decision-making by consensus over the voting procedures allowed for in the rules.

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[63] Article XII:2 of the *Marrakesh Agreement* stipulates that decisions on accession of new Members are to be taken by a two-third majority vote of the Ministerial Conference, but, in practice, except for the accession of Ecuador, these decisions have been taken by consensus in meetings of the General Council.

The difficulty with the decision-making procedures in the WTO, in my view, does not result from a "constitutional defect" in the rules, but rather from the preferences and the practice of the Members of the WTO. Changing the procedures for taking decisions is not likely to change the attitudes of WTO Members. Furthermore, changing the decision-making rules would only exacerbate the problems of internal legitimacy within the WTO, because it would increase the perceptions of developing countries that they are not included in the decision-making processes.

During the Uruguay Round, the United States put forward a proposal in the Functioning of the GATT System (FOGS) Group that a management board or committee, consisting of approximately 18 Members, should be established to set policy direction and assist in the management and administration of the system. That idea has resurfaced both among delegations in Geneva and in academic debate;[65] however, the developing countries remain opposed to any suggestion that would lead to some countries being excluded from any decision-making body.

Despite the objections of smaller and developing countries, a management board is essential and could be made to work in a way that would be inclusive of all WTO Members. The WTO has become a complex enterprise—there are many administrative, procedural and housekeeping decisions that could be made by a smaller body than the General Council. It is clear, particularly after the Seattle fiasco, that a smaller management body is needed to help set priorities and provide direction for the system. Informal groupings exist presently within the WTO—there is an African Group, made up of all the African countries in the WTO, which meets and develops coordinated positions on a regular basis. There is also an ASEAN Group, which meets regularly and takes coordinated positions in key WTO meetings. The Latin American countries have often acted in a coordinated fashion—they walked out *en masse* and blocked the Brussels Ministerial Meeting in 1990 over the contentious negotiations on agriculture. A management board or committee, structured so that it was truly representative of the WTO Membership, could be made to work in a transparent and inclusive manner. It could also help to move proposals forward and to alleviate some of the lengthy delays and paralysis caused by the existing cumbersome procedures.

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[64] Article XXV of the GATT 1947 stipulated, as a general rule, that decisions of the CONTRACTING PARTIES were to be taken by a majority vote (except for waivers and amendments that required a two-thirds majority). However, the practice, throughout most of GATT history, was for decisions to be taken by consensus.

[65] Sylvia Ostry has long been a strong proponent of this idea. See, for example: Sylvia Ostry, "World Trade Organization: Institutional Design for Better Governance", in Porter, Sauve, Subramanian & Zampetti, *Efficiency, Equity, Legitimacy: The Multilateral Trading System at the Millenium*, Brookings, 2001, 361- 380; Barfield, note 4.

Conclusions

In my view, the solution to the legitimacy crisis in the WTO lies not in turning back the clock and returning, as some have suggested, to a dispute settlement system grounded in diplomatic custom and practice. Nor does it lie in encouraging greater "flexibility and Member control" over the panel and Appellate Body processes. This sounds ominously like political interference with the judicial system. It is extremely important that the independence and impartiality of the judicial processes in the WTO not be diminished or threatened.

The key lies in recognizing that the WTO dispute settlement system has two tracks: one is "diplomatic" and the other is "judicial". A clear distinction must be made between the two.

WTO Members should be encouraged to make more and better use of the alternative dispute resolution ("ADR") mechanisms available to them under the DSU. Improvements to the "diplomatic" mechanisms to make them more effective would increase recourse to them by WTO Members and result in more cases being settled by diplomatic means.

At the same time, the independence, impartiality and integrity of the "judicial" system should be maintained and defended against political interference—a hybrid version of the judicial track is not in the interest of WTO Members nor is it consistent with a "rules-based" international trading system. The "judicial" system should be strengthened and improved by "professionalizing" the panel system, and giving it the attributes of a standing, independent tribunal based on the model of the Appellate Body. Transparency in panel and Appellate Body proceedings should also be guaranteed by making submissions of parties available to the public and by opening up panel meetings and Appellate Body hearings to the public. At the same time, new rules for the protection of "business confidential" information and workable procedures for admission of *amicus curiae* briefs should also be developed by WTO Members.

The "external" legitimacy problem of the WTO is a far greater threat to its continued viability than its "internal" legitimacy difficulties. For that reason, the WTO must move, and be seen to move, decisively and purposefully in the direction of greater transparency and openness. There is simply no excuse, given the gravity and importance of the decisions being made by the WTO, for a dispute settlement system or a legislative system that operates in secret, behind closed doors. Governments will not lose control over the WTO if non-state actors are permitted access to information, to attend hearings and meetings as observers, and to submit *amicus curiae* briefs to panels and the Appellate Body. By making the WTO more transparent and accessible, it will be better understood and appreciated. This will help to enhance the legitimacy and credibility of the WTO as an international organization.

The Evolution of GATT/WTO Dispute Settlement

Marc L. Busch and Eric Reinhardt*

Introduction

Despite debuting to little fanfare under the General Agreement on Tariffs and Trade (GATT), dispute settlement under the World Trade Organization (WTO) has been called the "backbone of the multilateral trading system."[1] Indeed, whereas GATT dispute settlement could scarcely have seemed more flawed,[2] the WTO's Dispute Settlement Understanding (DSU) is widely touted for boosting confidence in an increasingly rules-based global economy.[3] Why such starkly different views of GATT and WTO dispute settlement? The conventional wisdom is that the GATT's diplomatic norms have been supplanted by the WTO's more legalistic architecture,[4] resulting in a system in which "*right* perseveres over *might*."[5] Perhaps unsurprisingly, many observers insist that a wider variety of Members—and *developing* countries, in particular—are achieving more favourable results in dispute settlement due to the reforms introduced with the DSU and the WTO's greater clarity of law.

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[1] Moore 2000.

[2] Castel 1989; Young 1995; Pescatore 1997.

[3] Petersmann 1997; Steger and Hainsworth 1998; Horn and Mavroidis 2001.

[4] See Jackson 1978; 1998.

[5] Lacarte-Muro and Gappah 2000, 401.

Is this account borne out by the data? And does the empirical record offer clues as to the likely efficacy of further refinements of the DSU?

This chapter takes up these questions, offering statistical evidence on patterns of dispute settlement under the GATT and WTO regimes. The results help disentangle two related hypotheses in the literature. The first hypothesis is that the WTO has had greater *success* than the GATT in inducing favourable policy outcomes in dispute settlement. At first glance, the data would appear to confirm this hypothesis: roughly three-fifths of disputes filed under the GATT resulted in at least partial concessions[6], a percentage that increases to four-fifths under the WTO. But there are two important caveats to add here, one being that, unlike their richer counterparts, poorer complainants have not clearly received greater concessions from defendants in the WTO era, the other being that the WTO has fared no better than the GATT in resolving disputes between the US and European Communities (EC). Still, the bigger picture is that the WTO *has* improved on the GATT's surprisingly strong performance for an important category of cases, raising the question: Why?

The second hypothesis speaks to this question, attributing the WTO's successes to the DSU's legal reforms. In contrast to the GATT's diplomatic norms, which were criticized for lacking the "teeth" necessary to induce compliance, the DSU has been described as perhaps being "the most developed dispute settlement system in any existing treaty regime."[7] In particular, the DSU fills in where the GATT seemed to fall so terribly short, notably by formalizing a complainant's right to a panel, providing for the automatic adoption of panel reports (save by "negative consensus"), affording appellate review, and establishing a mechanism with unified jurisdiction over all disputes arising under the covered agreements. Many observers subscribe to the view that, as a result of these legal reforms, WTO dispute settlement unfolds differently than under GATT. The data tell a different story: *early settlement*, which we define as concessions negotiated in advance of a ruling, yields the most favourable policy outcomes under the WTO, much as it did under the GATT. Dispute settlement provides a forum in which Members bargain in the "shadow of the law;" while WTO adjudication yields less ambiguous and more binding legal decisions, the evidence suggests that the DSU's reforms *per se* have *not* made early settlement more likely, as compared to the GATT system. In fact, certain aspects of these legal reforms have made early settlement *less* likely in key respects, placing developing countries, in particular, at a disadvantage.

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[6] By concessions we mean measures by the defendant to liberalize its contested trade measure(s), conceding to some or all of the complainant's demands.

[7] Palmeter 2000, 468

This finding runs counter to conventional wisdom; the risk of pro-plaintiff rulings by panels and the Appellate Body (AB), which carry greater weight under the WTO, would be expected to induce *more* early settlement, yet this is not happening. Together with evidence on the lack of compliance with rulings more generally, this finding casts doubt on the hypothesis that the DSU's legal reforms *per se* deserve credit for the WTO's successes. Rather, the WTO's improved record appears to owe more to the expanded scope of "actionable" cases under new agreements, and the propensity for wealthy complainants to prevail over developing countries, the latter being more likely to be defendants in WTO than GATT cases. These results warrant careful consideration in weighing proposals for dispute settlement reform in the Doha Development Agenda.

This chapter proceeds in five sections. Section II explains the logic of early settlement. Section III provides an overview of GATT dispute settlement, looking at the impact of legal reform on patterns of early settlement. Section IV turns to the DSU, paying special attention to the experience of developing countries and the transatlantic relationship. Section V takes up several of the more salient reforms proposed for dispute settlement under the Doha Development Agenda in light of these findings. Section VI concludes.

Explaining Early Settlement

What explains early settlement in the shadow of "weak" law? In domestic litigation, the expectation is that plaintiffs withdraw cases lacking merit, and defendants plead meritorious cases. But this happens in the shadow of "strong" law, backed by credible enforcement. Under the GATT, which was long derided as a "court with no bailiff,"[8] rulings could hardly have been argued to carry much legal weight, assuming these rulings were adopted in the first place. Even under the WTO regime, where defendants are more likely to face binding rulings, compliance remains a question mark, given the difficulty of following through on authorization to retaliate, assuming the complainant even asks for such authorization.[9] What, then, explains early settlement in GATT/WTO disputes?

It has been shown that the answer is rooted in the way *uncertainty* about the disputants' resolve enters into the bargaining process.[10] Consider, for example, a complainant that can file for dispute settlement or resort to unilateral retaliation with a domestic trade measure (e.g., Section 301), which may carry its own domestic political costs. The defendant, meanwhile, must weigh various considerations: the economic damage from potential retaliation; the desire to avoid the normative condemnation elicited by overtly breaking the trade rules; possible strategic concerns about setting a precedent which could, in turn, spark a wave of future non-compliance by others; or narrower tactical considerations (e.g., a defendant's executive branch, or other liberalizing domestic groups, may be better able to overcome domestic protectionist opposition by "tying hands" with a ruling[11]). There is accordingly inherent uncertainty both as regards the complainant's will to follow through on costly retaliation and as regards the defendant's will to bear the costs of non-compliance. Both the complainant and defendant seek to exploit this uncertainty concerning their own course of action to their own advantage, leveraging concessions or upholding the status quo, respectively. The complainant's (often low-probability) estimate that the defendant is going to concede in the event of an adverse ruling leads it to set a high bar for the kinds of early settlement offers that it will accept. At the same time, the defendant's desire to avoid normative condemnation, compounded by the desire to forestall potential retaliation, induces the defendant to meet the complainant's (high) demands and thus to offer more generous concessions up front than after a ruling. The increased value of concessions in early settlement is thus a product of the *anticipation* of both normative condemnation[12] and market punishment. The twist here is that the uncertainty about the defendant's preparedness to incur the costs of non-compliance ends once the ruling is issued and the defendant acts, or fails to act. Rulings thus eliminate the uncertainty that serves, *ex ante*, as the basis for the complainant's heightened resolve, and thus the defendant's richer early settlement offer. This *anticipation*, and not the *realization* of a ruling, is thus the system's most effective means of extracting market-liberalizing concessions.

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[8] Rossmiller 1994, 263

[9] Five such requests have been made under the WTO, versus one under the GATT.

[10] Reinhardt 2001.

[11] Reinhardt 2002.

Sometimes settlement talks fail, and the dispute goes to a ruling. This occurs when there is little *ex ante* expectation either that the defendant would prefer to avoid the appearance of overt non-compliance, or that the complainant would be willing to retaliate in any event. In such cases the window for settlement is too small, such that the parties escalate the dispute fully. A ruling against the defendant, then, is most likely when an adverse ruling is *least* likely to affect the defendant's behaviour.

Our perspective on the dynamics of GATT/WTO dispute settlement provides a wide range of testable insights. Most important in this regard, concessions are more likely in advance of a ruling. This is not to say that the direction of a ruling is inconsequential, for in fact these verdicts do matter to the extent that non-compliance, given the system's norms, can be costly. Still, there is likely to be a nontrivial level of *non*-compliance with adverse rulings; such instances would occur disproportionately where defendants care less about these costs. More generally, market power, or asymmetric dependence, should be only a partial predictor of the defendant's level of concessions, for all the reasons outlined above.

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[12] As Hudec explained it, "the basic force of the procedure [comes] from the normative force of the decisions themselves and from community pressure to observe them." Hudec 1987, 214.

These predictions offer a window on the efficacy of likely reforms of the DSU. Most noteworthy, in this regard, is that, because retaliation depends on the resolve of the complainant, *not* the regime's official authorization, reforms such as those which eased approval for the suspension of concessions should have little impact on dispute outcomes. Similarly, because the regime's normative power lies in the interpretations of its rulings, not in their official legal force once adopted, reforms such as those which removed the defendant's ability to veto adoption should also have little effect. On the other hand, reforms that clarify the WTO's legal provisions should make panel decisions more predictable and GATT/WTO jurisprudence more coherent; this should *improve* the likelihood of realizing trade liberalizing. That said, reforms are unlikely to yield benefits to developing countries lacking the expertise required to navigate the complexities of the legal regime, especially if they favour recourse to litigation rather than to diplomacy and thus reduce the likelihood of early settlement, the stage of the process where concessions are most likely. In the sections below we discuss the empirical research to date on all of these separate implications of our model.

Before moving on, however, it is important to consider an objection to this entire line of reasoning: namely, that the "real action" may be unfolding long before a complainant brings a case to Geneva. This is the concern over *selection bias*: i.e., the possibility that unobserved factors distinguish those cases filed for dispute settlement from those dealt with through shuttle diplomacy, regional dispute settlement, or at other fora. If this were true, then inferences drawn from studies of dispute settlement might be "biased" by the way these unobserved factors lead some cases to be litigated in Geneva, and not others.

The most immediate problem, of course, is that data on "non-cases" are not available for the full GATT/WTO membership over time. There are, however, ways for future work to test for likely sources of selection bias. For example, in the case of sanitary and phytosanitary (SPS) measures, attention is being paid to the issues brought to the dispute settlement mechanism of the International Plant Protection Convention (which has dealt with a single case to date), and to the issues addressed at meetings of the WTO's SPS Committee and the Codex Alimentarius. These issues represent important leads, each with a paper trail, which hold promise as a way of distinguishing the types of cases that go to Geneva from those that do not, setting the stage for "selection effects" models. This research might look, for example, at whether questions debated at length under the Codex, or commented upon by a number of countries, are more likely to be filed for WTO dispute settlement. Along these lines, a recent study of US antidumping petitions finds that the determinations rendered by domestic agencies are strongly conditioned by the *threat* of foreign retaliation at the GATT/WTO, affording another angle on this question.[13] In the analyses below, selection effects models were estimated across stages *within* the life of filed disputes and were found wanting.

While it is obviously important to track down these "dogs that don't bark," the dogs that do bark also merit attention. In an important respect, dispute settlement is not an end *per se*, but a point of departure for key legal and political economy dynamics. Under the WTO, in particular, the question of "sequencing" with respect to the DSU Articles 21 & 22, the decision to follow through on authorization to retaliate, the process by which compliance is adjudicated after retaliation is authorized, and the political economy of designing and implementing new measures to replace old ones struck down, beg a closer look at dispute settlement as the starting point for interesting questions, rather than simply as the culmination of interesting questions.

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[13] Blonigen and Bown 2001.

GATT Dispute Settlement

First codified in an annex to the *1979 Understanding on Dispute Settlement*, the process by which GATT adjudicated trade conflicts shares much in common with the system set out by the DSU. Then, as now, a case would first manifest itself in a request for consultations. If a mutually satisfactory solution to the dispute were not struck in consultations, a complainant would then request a panel proceeding. Of course, the wrinkle in this story is that, under the GATT, a defendant could *block* the complainant's request for a panel, a possibility long regarded as one of system's most glaring birth defects. Interestingly, few defendants blocked requests for a panel.[14] Rather, they more frequently blocked the *adoption* of panel reports, taking advantage of GATT's other notorious shortcoming. For example, in both GATT-era *Bananas* disputes, the European Communities (EC) blocked the adoption of panel reports, revealing the challenge of winning a ruling against a recalcitrant defendant. Given the prospect of being denied a panel proceeding, let alone a favourable panel report, one could be forgiven for wondering why complainants would ever have made use of GATT dispute settlement, never mind that they did so quite often, and often quite successfully.

The *1989 Dispute Settlement Procedures Improvements* closed the first of these loopholes, giving complainants the right to a GATT panel. Although the threat of non-adoption still loomed large, defendants could no longer block, or significantly delay, a panel request. In the GATT-era *Bananas* cases, for example, the EC conceded that the *Improvements* had removed the tactic of delay, and urged that the panel not proceed too quickly in hearing this complicated case.[15] In this sense, the *Improvements* gave complainants a way to escape the "power politics" of the consultation stage. Perhaps not surprisingly, the *Improvements* were thus argued to have revitalized dispute settlement[16], given GATT "teeth,"[17] and encouraged the paneling of disputes more generally.[18]

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[14] Van Bael 1988, 68; Vermulst 1995, 134; Vermulst and Driessen 1995, 135. That said, some of the GATT-era cases were pre-emptive blocked, *EC—Hormones* being among the more salient examples. See Busch and Reinhardt 2003a.

[15] GATT document C/M/264.

The data tell a different story. Looking at Table 1, the *Improvements* did not lead to a greater propensity to panel disputes. Overall, panels were requested in less than half of all GATT cases. In fact, rates of paneling before and after the *Improvements* were 43 percent and 45 percent, respectively, a statistically insignificant difference.

Table 1. Patterns of GATT/WTO Dispute Escalation

	Disputes Initiated ...			
Stage of Escalation	**1948-2000**	**1948-1988**	**1989-1994**	**1995-2000**
Initiated ...of which	659	310	122	227
Panel established ...of which	305 (46.3%)	133 (42.9%)	55 (45.1%)	117 (51.5%)
Panel ruling issued ...of which	230 (34.9%)	105 (33.9%)	45 (36.9%)	80 (35.2%)
Appellate ruling issued	—	—	—	60 (26.4%)

Note: Since adjudication in the first years of the GATT relied less on formal panels than on other bodies (e.g., working parties or the entire Council) to issue judgments, the term "panel" above includes those alternative authorities as well. The figures in parentheses reflect the row's percent of the total cases initiated in that period (column). Cases filed after December 31st, 2000 are not included.

Of course, it could be that the *Improvements* induced more early settlement, not more paneling. Here, the logic would be that the right to a panel motivated defendants to plead meritorious cases in consultations. However, recent empirical work suggests that neither the *Improvements* nor the *Understanding* helped sponsor more early settlement.[19]

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[16] Castel 1989.

[17] Montana i Mora 1993; Young 1995.

[18] Pescatore 1993, 29

Which pairs of disputants were most likely to settle early under the GATT? Interestingly, pairs of highly democratic states (measured on a 20-point scale) were especially likely to negotiate up front. Consider three hypothetical cases: US-Canada, India-Canada and Brazil-Canada, which, respectively, obtain the maximum, the 25th percentile and 10th percentile "joint democracy" score in a sample of all GATT cases. Controlling for other attributes of these cases, the US-Canada case would have been only 3 percent more likely to settle in consultations than the India-Canada case, but fully 21 percent more likely to settle early than the Brazil-Canada case. This is especially noteworthy in light of the finding that the US and Canada would have been *no* more likely to make concessions at the *panel* stage than other pairs of disputants.

Further empirical work shows this relationship occurs in WTO disputes as well. This suggests that pairs of highly democratic countries benefit from having more latitude to negotiate in consultations before the case gains visibility at the panel stage, where both international and domestic "audience costs,"[20] and thus electoral concerns, are likely to weigh heavily on these governments. True, an adverse ruling is likely to inspire greater concessions from a defendant than is a ruling upholding the status quo (see Table 2),[21] but the point is that the *overall* level of concessions after a ruling is expected to be lower than in cases ending prior to a ruling, just as the evidence presented earlier indicates.

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[19] Busch 2000.

[20] Fearon 1997.

[21] The one GATT-era case in which the defendant conceded despite a ruling fully in its favor was the US vs. Netherlands dispute, Action under Article XXIII:2. This case, an early GATT-era equivalent of a WTO 22.6 panel, concluded that the proposed Dutch retaliatory quantitative restriction on US wheat flour (57,000 metric tons) was the appropriate level. The Netherlands formally kept the quota on the books for 7 years but declined throughout to enforce it, allowing uncapped imports from the US in practice (Hudec 1993, 430).

The data also permit a closer look at *compliance* with rulings. With respect to the GATT era, many observers are of the view that non-compliance was relatively uncommon.[22] The data suggest otherwise. In just two-fifths of cases ending with a pro-plaintiff ruling did the defendant fully liberalize, while in another third of these cases the defendant failed to comply at all, opting to spurn these verdicts (including through non-adoption). The point is *not* that the institution was ineffective, but rather that, as above, whatever positive effect it had on a defendant's willingness to liberalize tended to occur before a ruling in the form of early settlement. Put most simply, the institution's effectiveness cannot be gauged by looking at compliance alone.

The key question, of course, is how *outcomes* of disputes vary across these different stages of dispute settlement. Following Robert Hudec,[23] outcomes are defined here as the policy result of a dispute, rather than the direction of a ruling *per se*. In other words, the issue is whether the defendant liberalized its contested trade measure(s), conceding to some or all of the complainant's demands, and not whether the ruling (if one was issued) favoured either the complainant or defendant (or was mixed). Using this benchmark, which has meaning at every stage of dispute settlement from consultations to a panel, Hudec codes the outcome of each dispute into one of three categories, depending on whether challenged practices were fully or partly liberalized, or the status quo prevailed. Data on outcomes for all GATT disputes are presented in Table 2.

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[22] Jackson 1989, 101; Chayes and Chayes 1993, 187-8; Davey 1993, 72; Hudec 1993, 278-9; Petersmann 1994, 1192-5. In contrast to Hudec (1993), for example, we include post-1989 disputes, in which he, too, observed a high level of non-compliance.

[23] Hudec 1993.

Table 2. The Pattern of Dispute Outcomes, 1948-1994

	Level of Concessions			
Final Disposition of Case	**None**	**Partial**	**Full**	**Total**
Panel not established	67	53	54	174
Panel established, no ruling	7	5	23	35
Ruling for complainant	23	29	49	101
Mixed ruling	6	8	6	20
Ruling for defendant	24	0	1	25
Total	127	95	133	355

Note: As in Table 1, since adjudication in the first years of the GATT relied less on formal panels than on other bodies (e.g., working parties or the entire Council) to issue judgments, the term "panel" above includes those alternative authorities as well. "Ruling" above refers to the issuance of reports and not their formal adoption by the Contracting Parties.

The data reveals that defendants offered full or partial concessions in two-thirds of all disputes brought to the GATT. Interestingly, the likelihood of a plaintiff obtaining concessions was actually greater before (65 percent) than after (63 percent) a ruling. Overall, the system was very efficacious, despite its legendary shortcomings. That said, in those cases that went the legal distance, 83 percent of the rulings handed down favoured the plaintiff, and yet concessions were offered in only 63 percent, pointing to the system's weakness at the compliance stage. More telling still, of all the concessions made, 59 percent were the product of early settlement, emphasizing the relative importance of this stage in the GATT process. Indeed, defendants were especially likely to offer concessions *after* a panel had been established, but *before* it had ruled, regardless of which way the verdict went.

WTO Dispute Settlement

Against the backdrop of the GATT, the DSU is viewed as a significant step forward in institutional design.[24] Indeed, the DSU has been heralded as "perhaps the most significant achievement of the Uruguay Round negotiations, *establishing what may be the most developed dispute settlement system in any existing treaty regime*."[25] By all accounts, it would be difficult to argue otherwise. After all, the DSU's much stricter timelines, the right to a panel (carried over from the *Improvements*), automatic adoption of reports (absent negative consensus), and review by a permanently-constituted Appellate Body (AB), to name the more salient provisions of the DSU, appear to correct many of the GATT's most obvious design flaws.

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[24] See Petersmann 1997; Steger and Hainsworth 1998; Horn and Mavroidis 2001.

First, speedier procedures with strict time limits are thought to boost confidence in the DSU, delivering "justice" more promptly, and beating various unilateral measures to the punch; notably US Section 301, which worked on a notoriously faster clock than the GATT system. Second, the right to a panel removes the threat of blocking (save for one meeting of the Dispute Settlement Body), a tactic long regarded as the *sine qua non* of GATT-era power politics. Third, standard terms of reference, and the automatic adoption of panel reports, lend greater legal coherence to the system as a whole, and obviate the threat of a unilateral "veto" by a recalcitrant defendant.[26] Fourth, the potential for review by the AB promises more consistency across rulings and a better-informed body of case law with which to reason through the merits of a dispute *ex ante*.[27] Together, these reforms are widely expected to promote greater liberalization on the part of errant defendants in a timely manner.

Unfortunately, the DSU's legal reforms may also *raise* the transaction costs inherent in settling disputes by affording new opportunities for delay, increasing incentives for foot-dragging in litigation, and motivating defendants to delay concessions.[28] Granted, each separate stage of the process now operates according to a tighter timeline, but this is overwhelmed by the new possibility—indeed, the *inevitability*[29]—of successive rounds of litigation in the same dispute, culminating in up to a 15-month grace period for implementation,[30] the possibility of an Article 21.5 "compliance" panel review (and possibly appeal thereof), and additional litigation under an Article 22.6 panel tasked with arbitrating the amount and form of retaliation. Put simply, a determined defendant can wring three years of delays from the system before facing definitive legal condemnation, more than enough time for "temporary" measures—like the 2002 US steel safeguards—to impair competition without possibility for *retroactive* compensation.[31] Further, the added stages of litigation, tight enforcement of terms of reference, the legal disincentives for disclosure, and the rules on standing, all put the onus on disputants and third parties to legally mobilize as soon as possible in order to avoid losses on technicalities (i.e., having the panel or AB deem a certain argument outside its terms of reference) later on.

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[25] Palmeter 2000, 468. Emphasis added.

[26] Palmeter and Mavroidis 1998.

[27] Howse 2000.

[28] Shoyer 1998; Reinhardt 2002.

At the outset of a dispute, the concern for post-ruling delays, in particular, has the effect of undermining early settlement.[32] This is especially true if the rush to litigation draws in third parties or additional disputants, whose involvement has been shown to reduce the prospects for concessions by a defendant.[33] In the wake of a ruling, the DSU's superiority in eliciting compliance is also vastly overstated in relation to the GATT; the hurdle, in this regard, has never been obtaining legal authorization *per se*,[34] but mustering the political will—and having the market power—to retaliate. In this sense, as one noted observer puts it, "[t]he 'legalization' of disputes under the WTO stops, in effect, roughly where non-compliance starts."[35] How, then, has the DSU influenced patterns of dispute settlement?

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[29] Of the eleven initial panel reports in the dataset of completed US-EC WTO cases below, only *Section 301* and *US Copyright Act* were not appealed. And in the latter case, no fewer than three separate arbitrations were invoked, under Articles 23.1(c), 25, and 22.6, governing the "reasonable period of time" for implementation, the level of nullification or impairment, and the level of retaliation.

[30] The grace period in *Australia—Salmon* was eight months, but generally it has been much longer.

[31] Mavroidis 2000; Pauwelyn 2000.

[32] Stewart and Burr 1998, 514.

[33] Busch 2000.

[34] Hudec 1999, 9-10; Mavroidis 2000; Valles and McGivern 2000; Reinhardt 2001.

Developing countries

A glance at the data on concessions between 1980 and 2000 reveals the WTO boasts a more favourable track record than the "mature" GATT period: overall, defendants have liberalized disputed policies more fully since the DSU came on line.[36] The data further reveals, however, that developing-country complainants have not benefited as much under the WTO as wealthier complainants. On the one hand, *developing*-country complainants gained full liberalization from defendants 36 percent of the time under the GATT, a figure that has risen to 50 percent under the WTO. On the other hand, this is far surpassed by the gains achieved by *developed*-country complainants, which secured full liberalization from defendants 40 percent of the time under the GATT, but 74 percent of the time under the WTO. Why are developing countries falling short? The answer is that these countries are failing to induce defendants to settle early, *not* that they disproportionately receive unfavourable verdicts, or that they lack the market power necessary to (credibly) retaliate.

Recent empirical work estimates the probability of full concessions by a defendant, looking at the influence of the WTO (versus the GATT) and the complainant's level of development (i.e., per capita income). The complainant's absolute market size (overall GDP) as well as the income and GDP of the defendant are controlled for, as is the question of whether a panel was formed, the direction of any ruling, whether the case had multiple disputants or third parties, whether the case centered on an agricultural policy, strictly discriminated against the complainant, or was politically "sensitive" (i.e., a health and safety standard).

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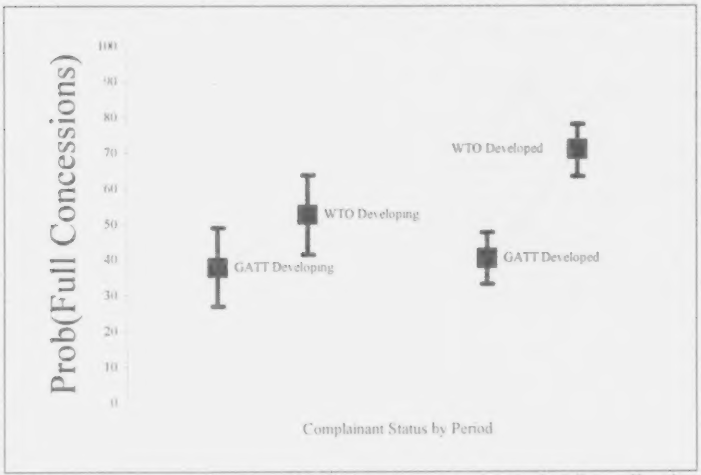
[35] Pauwelyn 2000, 338.

[36] Busch and Reinhardt 2003b.

To identify the effect of the complainant's level of development as conditioned by the WTO, this interaction term was also included. Importantly, the interaction term is positive and statistically significant, meaning that the WTO has *increased* the gap between developed- and developing-country complainants with respect to their ability to get defendants to offer concessions. In short, rich complainants have become significantly more likely to secure their desired outcomes under the WTO; for poorer complainants the situation is less clear.

Figure 2 graphically depicts this. Holding all other variables at their sample means, the predicted probability of a poorer complainant (with a 10th percentile GDP per capita value of about $2,150) securing full concessions from a defendant was between 0.27 and 0.49 under the GATT, and is between 0.41 and 0.64 under the WTO. These ranges are 90 percent confidence intervals, so the fact that there is still wide overlap between them (from 0.41 to 0.49) is interesting. The data, so far, hints that developing countries have improved their performance as complainants, but they by no means allow any reasonable degree of certainty about this trend. At the same time, the situation for a wealthier complainant (with the 90th percentile GDP per capita value, of $29,250) has unambiguously improved under the WTO. The predicted probability of full concessions for a country fitting this description was between 0.33 and 0.48 under GATT—which is on par with an equally-sized, poorer complainant—but has risen to between 0.63 and 0.78 under the WTO. Interestingly, this finding does *not* hold for US-EC disputes, which in fact have been *no more likely* to end favourably under the WTO (see below). The point to keep in mind is that these results regarding developing countries are not an artefact of the exceptional prominence of the US and EC as complainants.

Figure 2. Probability of Full Concessions by Complainant Status and Period



NOTE: Displays predicted probabilities from Model 1, holding all other variables at their sample means, moving *WTO* from 0 to 1 and *Complainant's Per Capita Income* from its 10th percentile value ($2,152) to its 90th ($29,251), with 90 percent confidence intervals.

The data tell the same story when the analysis is limited to WTO disputes. Once again, holding all other variables at their sample means, and varying the complainant's per capita GDP from its 10th to 90th percentile values, the predicted probability of the defendant offering full concessions more than doubles, shifting from 0.22 to 0.47. Consider the case of India and Australia, two countries with virtually identical GDPs in 2000 (467 vs. 457 billion 1995 US$[37]) but very different per capita income levels of $459 and $23,837, respectively. The model predicts that India would have a 41 percent chance of getting the average defendant to concede, while Australia's comparable figure is a striking 73 percent.[38] As above, this model controls for the complainant's GDP, characteristics of the defendant, panel formation and rulings, and observable attributes of the dispute.

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[37] World Bank, World Development Indicators, 2002.

[38] Indeed, in Busch and Reinhardt's (2003b) sample, Australia induces defendants to concede in 3 of 3 WTO complaints, while India secures only

If there is a new gap, what accounts for it? Put differently, at what point in the escalation of a case does the complainant's level of development hamper its chances for obtaining full liberalization from a defendant?

To find out, consider the probability of early settlement in the 154 WTO disputes concluded to date. Again, the main variable of interest is the complainant's per capita income, controlling for its absolute market size and other attributes of the dispute. Here, too, this variable is positively signed and statistically significant; rich complainants are more likely to get defendants to settle early than are poorer complainants, holding GDP constant. This suggests that developing-country complainants disproportionately fail to negotiate concessions in advance of a panel ruling.

Could it be, instead, that these countries are disproportionately losing verdicts? The answer is no. Looking just at those WTO cases in which rulings are issued, and estimating the direction of a ruling with the same covariates outlined above, the complainant's income (and market size) has no effect on its prospects of winning a judgment, where one is issued. In other words, the gap in securing full concessions from a defendant is *not* a function of poor legal acumen once litigation is underway. Rather, the problem is that developing-country complainants are losing out in pre-litigation negotiations.

Finally, could the gap, instead, be a result of developing countries' failure to secure compliance by defendants against whom adverse rulings have been issued? After all, given their market size, would it not seem reasonable to suspect that these complainants' retaliatory threat is insufficiently credible? Here, too, the answer appears to be no. Looking just at the 41 cases in which a WTO ruling went fully against the defendant, the complainant's income has no effect. A rich complainant, in other words, has no discernable advantage over a poorer, but equally-

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partial liberalization in 3 of its 6 complaints, with no concessions whatsoever in a fourth.

sized, developing-country in eliciting compliance from a defendant that is found in violation of its WTO obligations.

Hence the picture that emerges is that poor complainants tend to have less well-prepared cases up front, losing out on the opportunity to use the "shadow of the law" effectively against defendants. With their larger share of weakly-briefed cases selected out, poor complainants fare no worse in those cases that end with further litigation. This problem has become particularly acute under the WTO, which has put a greater premium on legal argumentation in the early life of disputes.

The transatlantic relationship

The importance of early settlement is no less evident in US-EC disputes. If Washington and Brussels fail to resolve their trade tensions prior to a panel ruling, the likelihood of concessions drops precipitously.[39] Indeed, concessions offered in the transatlantic relationship are typically had in advance of a ruling, or not at all. Most compelling in this regard is that, no matter how the panel rules, a verdict *reduces* the prospects for concessions, even under the WTO. In other words, the data suggest that the prospect of resolving a dispute falls when these two countries do not settle early. This supports the thrust of former WTO Director-General Renato Ruggiero's observation that, while "[t]he WTO dispute settlement system is in some ways the first international economic court … it is still preferable for the Member countries involved to discuss their problems and try to resolve them … before actually resorting to a panel."[40]

A quick tabulation of US-EC concessions under the GATT and WTO reveals greater concessions under the latter institution. Part of the challenge in making this assessment is that the WTO has extended its reach into intellectual property (IP) and traded services through the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) and the General

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[39] Busch and Reinhardt 2003a.

[40] Director General Ruggiero's 1998 speech at the University of Trieste http://www.wto.org/english/news_e/sprr_e/triest_e.htm

Agreement on Trade in Services (GATS), respectively. As a result, more disputes are actionable under the DSU. This is not to say that disputes in IP and traded services eluded the GATT, for in fact GATT handled a small, but highly contentious, set of cases touching on these areas, with little effect on the status quo.[41] For its part, the WTO has adjudicated nine US-EC disputes in IP and traded services, as listed in Table 3.

Table 3. US-EC IP and Services Disputes under the WTO

DS	Start	Compl. / Def.	Title	End	Level of Concessions
37	30-Apr-1996	US vs. PT	Patent Protection Under the Industrial Property Act	1996	Full
80	2-May-1997	US vs. BE	Measures Affecting Commercial Telephone Directory Services	1998	Full
83	14-May –1997	US vs. DK	Measures Affecting the Enforcement of IP Rights	2001	Full
86	28-May –1997	US vs. SE	Measures Affecting the Enforcement of IP Rights	1998	Full
82, 115	14-May –1997	US vs. EC, IE	Measures Affecting the Grant of Copyright and of Neighbouring Rights	1998	Full
124, 125	30-Apr-1998	US vs. EC, GR	Enforcement of IP Rights For Motion Pictures and Television Programs	2001	Full
160	26-Jan-1999	EC vs. US	Section 110(5) of the US Copyright Act ("Irish Music")	2002*	Partial*
174	1-Jun-1999	US vs. EC	Protection of Trademarks and Geographical Indications for Ag. Products	2002*	Partial*
176	8-Jul-1999	EC vs. US	Section 211 Omnibus Appropriations Act ("Havana Club")	2002*	Full*

* denotes cases with apparent but still tentative policy outcomes.

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[41] Neither did the US or EC budge as defendants in IP/services complaints brought by third parties under the GATT, e.g., Austria v. Germany *Truck Traffic Restrictions* (1990) and Canada v. US *Spring Assemblies* (1981).

A closer look at these IP and traded services disputes is revealing. In particular, five of these nine cases are US complaints designed to speed up passage of domestic legislation, designed to implement TRIPs obligations by individual EC member states (Portugal, Denmark, Sweden, Ireland, and Greece). It can thus be argued that these cases were much less acrimonious than most, given that the TRIPs commitments were already manifest in (proposed) domestic legislation. Indeed, not one of these disputes was paneled, the upshot being that, as Table 3 indicates, all ended in full concessions. In the other four IP and traded services disputes, the defendant conceded partially or fully, mostly before a panel ruling.

This is not to say that IP and traded services disputes are easily resolved. On the contrary, IP disputes are viewed as among the most technical and difficult, requiring a considerable outlay of resources on the part of the disputants (and the WTO). The point is that the TRIPs and GATS have induced, probably on a one-time basis, a special set of disputes distinguished by their direct relationship to these new commitments, and were thus ready-made for fuller concessions. In short, better dispute settlement procedures *per se* did not force the defendant's hand in these cases.

If the WTO's expanded scope is controlled for, does it still perform better than the GATT in settling US-EC disputes? Recent empirical work estimating the level of concessions offered by the defendant in the 85 GATT/WTO transatlantic disputes suggests not. The models include a variable reflecting whether the case was brought under the GATT or WTO procedures, involved WTO-era IP or traded services issues, whether a panel was established, the direction of a ruling (if one was rendered), whether the US was the complainant, and whether the dispute concerned agriculture, involved multiple complainants or third parties, a strictly discriminatory measure, and covered sensitive issues like health and safety standards. The results are revealing. While the variable for WTO-era disputes involving IP and traded services is positively signed and statistically significant, the WTO variable itself is not. The model indicates that, holding all other variables at their sample means, a dispute over IP or traded services is 43 percent more likely to conclude in full concessions by the defendant under the WTO than under the GATT. In contrast, the probability of concessions by defendants, more generally, is *no more likely* than under the GATT.[42] Keep in mind that this result accounts for the differing legal dispositions of each case.

The model produces a number of other interesting quantitative results. Specifically, defendants are 22 percent *less* likely to concede in multilateral as opposed to purely bilateral disputes; 43 percent *less* likely to make concessions in SPS or cultural cases; yet 33 percent *more* likely to concede in cases involving purely discriminatory measures; and 24 percent *more* likely to make concessions in agricultural cases. Most telling, the defendant is far more likely to concede in *advance* of a ruling, rather than after, regardless of the direction of the ruling. Starkly, a ruling for the defendant reduces the probability of full concessions by 63 percent; a mixed ruling by 43 percent; and a ruling for the *complainant* by roughly 25 percent. Clearly, when the US and EC litigate to a verdict, concessions in transatlantic disputes are *less* likely.

One commonly held view in the literature is that the success of early settlement under the GATT is increasingly less evident under the WTO, especially in consultations.[43] While bargaining in the shadow of the law proved efficacious under the GATT's more diplomatic system, the argument is that the DSU's reforms may have made litigation attractive, motivating complainants to push for a definitive verdict. As evidence, many observers point not only to the caseload at the panel stage, but the frequency of appeals to the AB. Moreover, the received wisdom is that consultations are *pro forma* at best.

In fact, the proportion of cases paneled differs little across the GATT/WTO years; the WTO's greater caseload reflects growth in the institution's membership and in the volume of world trade.[44] In terms of the transatlantic relationship, more specifically, early settlement is perhaps more important than ever, a point quite evident in Figure 3, which graphs the level of concessions achieved in WTO disputes ending at various stages of escalation.

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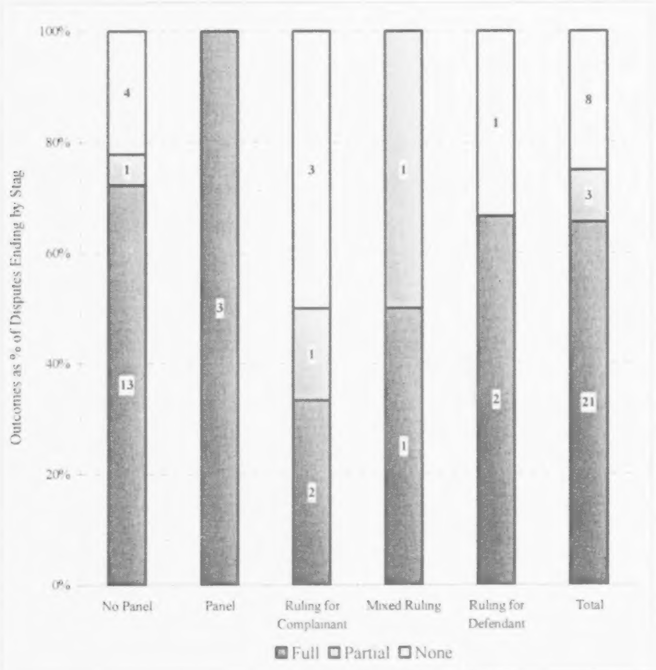
[42] The coefficient of *WTO Case* in Table [illegible] is positive but hardly larger than its standard error, so we cannot with statistical confidence reject the very likely possibility the WTO has had no effect whatsoever.

[43] Wethington 2000, 587.

Figure 3. Level of Concessions in US-EC WTO Disputes Ending at Different Stages of Escalation



NOTE: Darker blue area represents percent of cases ending at the given stage (e.g., prior to panel establishment) in which defendant fully concedes. Numbers in bars denote the actual number of cases in each subcategory; the total is 32. The listed ruling direction is that of the Appellate Body, not the panel, in appealed cases.

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[44] Busch and Reinhardt 2000.

The first point to make about US-EC disputes is that this dyad has tended to settle early at the GATT/WTO, with the defendant offering concessions in advance of a ruling 58 percent of the time. In the WTO years, this percentage stands at 66 percent (21 of 32 disputes). The more telling question, of course, is whether early settlement produces positive results. Of this there can be no doubt. The data tell a remarkable story: of the 21 US-EC disputes ending in *full* concessions at the WTO, 16 were resolved in advance of a panel ruling. If we set a lower bar and examine disputes in which *any* concessions were offered, the data favour early settlement by a margin of 17 to 7. In short, it is but a slight exaggeration to argue that favourable outcomes in US-EC disputes depend entirely on early settlement.

The obvious retort to this would be that early settlement is, itself, a reflection of the reforms ushered in by the DSU. In other words, the WTO's stronger law induces more early settlement. Although the logic is intuitively attractive, the data is entirely at odds with it. The key to this hypothesis would necessarily be that strengthened ability to induce compliance *ex post* is inspiring early settlement *ex ante*; yet there is no evidence that compliance is in any way more likely under the WTO than it was under the GATT.

Consider Figure 4, which compares the level of concessions by the defendant in US-EC disputes under the GATT versus the WTO, depending on the direction of the ruling. Under the GATT, a ruling for the complainant resulted in full concessions 63 percent of the time (10 of 16 cases); under the WTO, facing an adverse ruling, the defendant has fully conceded just 33 percent of the time (2 of 6 disputes).[45] Granted, with just 6 WTO rulings unambiguously against the defendant, it is difficult to compare these institutions with statistical confidence, yet at first blush the WTO is thus far inducing *less* compliance with adverse rulings in US-EC disputes. Hence, because compliance remains a significant problem, the WTO's increased legalism is probably not responsible for the institution's continuing dependence on early settlement for most of its *successful* dispute outcomes.

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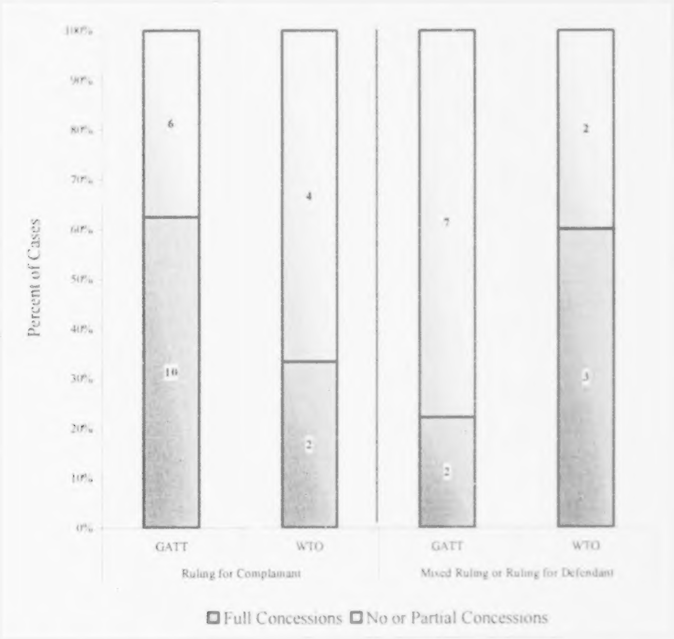
[45] *Bananas*, *Hormones*, *FSC*, and *Anti-Dumping Act of 1916* are the four WTO cases with no or partial compliance by this reckoning.

Figure 4. Level of Concessions by Ruling Direction under GATT and WTO, for US-EC Disputes



Could the WTO's greater legalism have improved upon the GATT at least in the *easier* transatlantic cases, if not the most difficult ones? If so, the infrequency of compliance does not necessarily mean dispute settlement is less efficacious, since higher-stakes cases may disproportionately go to panels and beyond. The fact that all 7 of the highest-stakes conflicts in Table 4 gave rise to rulings is certainly consistent with this explanation. Nonetheless, this interpretation of the evidence misses the point. First, quite a few transatlantic WTO disputes have ended with no, or limited, concessions by the defendant *without* being heard by a panel. For example, in *Flight Management Systems* (DS172), the US objected to a one-off $25 million French subsidy to Sextant Avionique, a supplier of avionics to Airbus, and yet the dispute died on the table. Just because a dispute involves small stakes, or does not continue through the litigation process, does not mean it will end with concessions by the defendant.

Table 4. High Stakes US-EC WTO Disputes

DS	Start	Compl. / Def.	Title	End	Level of Concessions
26	25-Apr-1996	US vs. EC	Measures Affecting Meat and Meat Products ("Hormones")	1999	None
27 (16)	5-Feb-1996	US vs. EC	Import Regime for Bananas	2001	Partial
62, 67, 68	8-Nov-1996	US vs. EC, UK, IE	Customs Classification of Certain Computer Equipment	1998	Full
108	18-Nov-1997	EC vs. US	Tax Treatment For Foreign Sales Corporations	2002*	None*
136	9-Jun-1998	EC vs. US	Anti-Dumping Act of 1916	2002*	None*
152	25-Nov-1998	EC vs. US	Sections 301-310 of the Trade Act of 1974 ("Section 301")	2000	None
165	4-Mar-1999	EC vs. US	Import Measures on Certain Products from the European Communities	2001	Full

* denotes cases with apparent but still tentative policy outcomes.

Second, if procedural reforms have induced more early settlement in US-EC conflicts because they darken the shadow of the law in anticipation,[46] why does the complainant in this pair sometimes fail to pressure the other side with the threat of a ruling, even in promising cases? The defendant failed to fully concede in *Harbor Maintenance Tax* (DS118) and *Trademarks and Geographical Indications* (DS174), but no panel was requested. Two ongoing disputes stand out in this regard. Of the 14 concluded US-EC WTO cases that went before a panel, the median delay between the request for consultations and the establishment of a panel was just 5 months. But the EC has not made a panel request in *Section 337* (DS186) and *Section 306* ("Carousel Retaliation", DS200), even 27 and 22 months, respectively, since the complaints were filed. If improved legalism is indeed responsible for early settlement, the EC seems to have missed a golden opportunity to use the threat of a ruling to leverage concessions from the US.

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[46] Jackson 2000, 174.

Third, if the most vaunted procedural reform—namely, removing the defendant's veto of the adoption of a report—has made early settlement more likely (at least in the easier cases), then we would expect much less early settlement of US-EC conflicts under the GATT rules, where defendants could block adoption of reports and panel requests. Yet early settlement was the hallmark of the GATT. Clearly the normative power of a GATT ruling, regardless of its legal adoption, was most important in this regard.[47] Early settlement in the WTO era is probably driven by the same dynamic.

One final, but highly salient, benchmark against which to assess the DSU's mettle would be to examine those GATT-era transatlantic cases that have been repeated under the WTO. If the DSU is truly an improvement over the GATT system, it might well be expected to induce better outcomes in those disputes that have recurred. Consider the 1972-1984 *Domestic International Sales Corporation* (*DISC*) and the 1997-2002 *Foreign Sales Corporations* (*FSC*) complaints by the EC against US tax practices that subsidize exports, along with the accompanying counter-complaints by the US against allegedly similar EC member state subsidies. The GATT-era *DISC* ruling, the adoption of which was blocked for many years, is legendary for its "faulty reasoning,"[48] and the dozen years before settlement speak poorly to the GATT's efficacy as well.[49] The relative rapidity, legal professionalism, and lack of veto of the WTO rulings on the EC's 1997 successor suit against the law implementing the *DISC* settlement, *FSC*, make the WTO shine in comparison.

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[47] Hudec 1999.

But in other ways the WTO record in *FSC* is no better. WTO legalism has allowed the EC to force the issue, so that it now confronts the option to retaliate with a "nuclear weapon"[50] (from $1-4 billion of sanctions per year), a costly proposition for both disputants. The EC's recent appeasing statements contrast sharply with those on lower-stakes cases against the US, indicating a recognition that a settlement, even one that provides a fiction of compliance, may be preferred.[51] (In this sense the EC faces the same outlook as Canada in *Export Financing Programme*, DS46.) The WTO panel missed a reasonable opportunity to forge a compromise, one more acceptable to the US Congress, by treating the case as linked to the earlier *DISC* settlement. The *DISC* settlement may have achieved little, but at least it helped defuse a contentious issue that could have had negative effects for the institution. What counts most, of course, is that the WTO dispute has not induced any more change in US policy than did the GATT dispute, despite the clearest legal rulings the institution could produce.

Hormones, *Harbor Maintenance*, and *Bananas* offer comparable testimony. The EC blocked a US panel request in the 1987 *Animal Hormones Directive* complaint and, in response, the US blocked the EC's request for a panel to rule against its subsequent unilateral retaliation.[52] Under the WTO procedures, unlike under the GATT, the EC has been unable to block definitive legal condemnation of its policy, but the US has once again retaliated, and the EC ban remains in place, much as before. Similarly, the EC has twice disputed the US policy of taxing shipping to pay for harbour maintenance (constituting an effective import tax), first in 1992 (*Harbour Maintenance Fees*) and again in 1998 (*Harbour Maintenance Tax*, DS118). Neither case was brought before a panel. While the Clinton Administration proposed a change that may have satisfied the EC, the necessary legislation was not passed. The best hope for change in the status quo now lies in US domestic litigation, not in further WTO action. Likewise, in the two GATT complaints against the banana import regimes of the EC and its member states, the EC blocked adoption of two adverse panel reports in 1993 and 1994. The DSB, of course, succeeded in adopting the WTO *Bananas* reports, yet the resulting EC concessions leave much to be desired in their scope and timeliness, and are, in any case, most likely attributable to other factors. Thus, it would be hard to argue that the WTO boasts a more favourable track record in dealing with these recurrent cases.

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[48] Jackson 1978, 781.

[49] Hudec 1993, 59-100.

[50] The term is US Trade Representative Robert Zoellick's (*International Trade Reporter*, May 17th, 2001, 778).

[51] For instance, an anonymous European Commission official has suggested that compensation rather than strict compliance might be acceptable in the *FSC* case, saying, "[we want] to avoid this issue becoming a major dispute" (*Financial Times*, January 15th, 2002).

[52] Hudec 1993, 545, 574-575.

Dispute Settlement Reform

Under the auspices of the Doha Development Agenda, members have submitted a myriad of proposals for reforming WTO dispute settlement. Most of these proposals focus on dynamics at the panel stage, from constituting a permanent body of panellists[53] to assessing developing countries' legal costs to those developed-country complainants that fail to win their case.[54]

The main policy implication of this chapter is that *proposals should strengthen the prospects for early settlement*. Echoing this, former Director General, Mike Moore, explained that "I am of the view that Members should be afforded every opportunity to settle their disputes through *negotiations* whenever possible.”[55] Moore’s submission aimed at generating interest in DSU Article 5 “good offices, conciliation and mediation,” which several developing countries also emphasize. For example, Paraguay has proposed that recourse to Article 5 be “mandatory” in disputes with developing countries,[56] whereas Jamaica has simply called for “more frequent use” of this long-neglected text.[57] The fact that Article 5 has never been invoked should caution against making its use mandatory, given that disputants appear to be concerned about the signal its invocation sends.

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[53] TN/DS/W/1.

[54] TN/DS/W/19.

Much the same is true of DSU Article 25 arbitration, which was used twice in the GATT years and once under the WTO, although as an Article 22.6 panel in this latter case (*US—Section 110(5) of the Copyright Act*).[58] Article 25.1 states that “[e]xpeditious arbitration within the WTO as an alternative means of dispute settlement can facilitate the solution of certain disputes that concern issues that are clearly defined by both parties.”

In light of the efficacy of consultations, it is somewhat surprising that Article 25 has not held out greater appeal as a cheaper and timelier mechanism. It may be that the rules, which are left to the discretion of the disputants, are too informal; alternatively, the efficacy of these negotiations may be hindered by virtue of the fact that they are an additional step removed from a panel. Disputants may also be concerned about an Article 25 arbitration award setting precedents inconsistent with the body of GATT/WTO jurisprudence,[59] despite the fact that recourse to DSU Articles 21 and 22 would remain in reserve (as set out in Article 25.4). Whatever the reason, it is puzzling that Article 25 has generated so little interest, especially in light of the proven efficacy of consultations.

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[55] WT/DSB/25. Emphasis added.

[56] TN/DS/W/16, pg 2.

[57] TN/DS/W/21, pg 1.

[58] WT/DS160/ARB25/1

[59] As referenced in the Article 25 arbitration award in *United States–Section110(5)* (DS160), the Arbitrators, reflecting upon the issue of it’s own jurisdiction, noted that the “parties to this dispute only had to *notify* the DSB of their recourse to arbitration. No decision is required from the DSB for a matter to be referred to arbitration under Article 25. In the absence of a multilateral control over recourse to that provision, it is incumbent on the Arbitrators themselves to ensure that it is applied in accordance with the rules and principles governing the WTO system.”

As concerns consultations *per se*, there are a number of recommendations that, in light of the analysis here, would likely do more harm than good. Most notably, in this respect, is Jamaica's recommendation that "there should be a written report from the consultations prepared and submitted to the DSB by the party requesting the consultations."[60] Theory makes clear that disputants will not "deal" if offers made in pre-trial discovery can be introduced as evidence before a judge or jury,[61] and a written record of consultations delivered to the DSB would surely have this effect. In the same vein, the proposal that developed countries be required to submit, in their requests for a panel, a record of how they afforded developing countries "special and differential" treatment runs the same risk.[62] That is, if a developed country is required to *document* its offers in consultations as a way of complying with Article 4.10, fewer (proposed) concessions are likely to be forthcoming at precisely that stage of dispute settlement where poorer countries need them most. More generally, the spate of calls to make consultations more accessible to the public, or bring a panel into the process,[63] are mistaken for the same reason, and should not be entertained simply because "transparency" is very much in vogue.[64]

How, then, can developing countries be assisted to achieve more early settlement in consultations? To help overcome resource constraints, the proposal by the *LDC Group* to hold consultations in the capitals of developing countries, where possible, is a useful start.[65] Building legal capacity is also key; the establishment of the Advisory Centre on WTO Law, for example, is an important step in this direction, as are Article 27.2 and

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[60] TN/DS/W/21, p. 1.

[61] Daughety and Reinganum 1995.

[62] TN/DS/W/19, 3.

[63] Parlin 2000.

[64] See, for example, Davey and Porges 1998, 699.

[65] TN/DS/W/17.

Article 27.3, which make legal expertise and training courses available to developing countries, respectively. The aim is to facilitate an assessment of the merits of a case *ex ante*, and to frame the contours of an acceptable negotiated settlement in advance of litigation. However, the proposal to have developed countries pay the legal bills for developing countries where the latter prevail may backfire,[66] since there would then be incentive to litigate for the purpose of recouping expenses. Instead, greater resources should be available up front, both in terms of access to legal expertise and training.

Beyond this, recommendations for reform at the panel and post-ruling stages of dispute settlement also hold out promise.

One potentially useful recommendation, in this regard, is to do away with interim reports. A hold-over from the GATT years, this "peak behind the curtain" is not only redundant in light of appellate review under the WTO, but counterproductive. Designed to maximize the potential for early settlement, distributing draft panel reports has, by all accounts, been misused by the disputants for political grandstanding, entrenching, rather than softening, their positions. Indeed, "the public often becomes aware of a dispute's outcome at the interim stage. … [and] the chances of settlement at this stage, already low to begin with, decrease even further."[67] In this light, interim reports may well do more harm than good.

To raise the prospects for early settlement, reforms should target post-ruling foot-dragging, in particular. Two recommendations stand out in this regard. First, while the "sequencing" question appears to have been (informally) answered, useful proposals have been made with respect to Article 21*bis*.[68]

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[66] TN/DS/W/19, 2; TN/DS/W/21, 3.

[67] Stewart and Karpel 2000, 640. As former Director General Ruggiero said, "The creation of… mis-impressions by selective leaks is highly undesirable because the mis-impressions are unlikely to be correctable later. Moreover, leaks reduce the likelihood of a mutually agreeable solution, which is the preferred result of the DSU and which is the basic reason for revealing the preliminary panel result to the parties in the first place" (WTO 1998, 32-33).

[68] Valles and McGivern 2000; WT/MIN(99)/8; TN/DS/W/1; TN/DS/W/21

These proposals would help streamline litigation in the post-ruling phase by: requiring a 21.5 compliance panel in advance of a 22.6 panel arbitrating the suspension of concessions, clarifying appeals of 21.5 panels, firming up the relevant timelines, and addressing how, after concessions have been suspended, a defendant's *subsequent* compliance is to be judged.[69] These recommendations would do much to reduce post-ruling foot-dragging, and would thus encourage more early settlement.

Second, while recognizing that the DSU is about compliance with obligations, *not* retaliation, the proposed reforms make clear that credible "enforcement" is a priority. To be sure, most recommendations nod to this concern; following through on authorization to suspend concessions is a daunting prospect, even for the US and EC, as *FSC* serves to remind. With respect to the hurdles facing developing countries, in particular, the possibility of "collective retaliation" has been proposed, the idea being that, "[u]nder this principle, all WTO Members would collectively have the *right and responsibility* to enforce the recommendations of the DSB."[70]

Less likely to raise collective action problems is the EC's proposal to allow for an errant defendant to offer "a compensation package for a value equal to the level of nullification and impairment…."[71] Such a payment might well diffuse trade tensions, but would appear to favour those who can pay over those who cannot, and in any case would leave standing measures that were in violation of WTO law, further lending to the appearance of a two-tier system. Alternatively, it has been proposed that, rather than tariffs, errant defendants be allowed to offer enhanced market access,[72] or that the complainant be allowed the right to choose the sector in which to suspend concessions, modeled on the experience in *EC—Bananas*.[73] While interesting, neither proposal directly addresses the incentives for foot-dragging in litigation.

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[69] WT/MIN(01)/W/6.
[70] TN/DS/W/17. Emphasis added. See also Pauwelyn 2000.
[71] TN/DS/W/1, 5.
[72] TN/DS/W/21, 4.
[73] TN/DS/W/19.

To remedy this, a growing chorus of voices proposes that the WTO offer *retroactive damages*.[74] Retroactive damages would undermine the use of protection as a domestic political "freebie" in the lead-up to a WTO ruling, as observed by Mexico in its proposal for retroactive damages.[75] Mexico goes on to explain that provisions for "retroactivity" are included in the WTO's Antidumping and Subsidies and Countervailing Measures agreements, and suggests that nullification or impairment could be assessed back to: "(a) the date of imposition of the measure; (b) the date of the request for consultations; or (c) the date of establishment of the Panel."[76] Few proposals would do more to reduce legal foot-dragging than providing for retroactive damages, and thus stimulate early settlement.

Conclusion

As was true under the GATT, early settlement is the engine of WTO dispute settlement. This is not to suggest that the system has failed to evolve. On the contrary, the DSU marks a substantial improvement over the GATT's less integrated, and often implicit, architecture. Taken together with the WTO's greater clarity of law, this bodes well for international trade. Indeed, there is much to admire about a more rules-based global economy, especially one backed by an institution like the WTO, which, despite its weaknesses, is better poised to adjudicate rights and obligations than its predecessor.

That said, it is just as important to appreciate the limitations of the system, particularly at the panel stage and beyond. The automaticity of panel reports brings pro-plaintiff rulings more within reach under the WTO, but by no means ensures market liberalization. Recognizing this, US Trade Representative Robert Zoellick explained that "[w]e must be more creative in settling bilateral disputes.... *Litigation is not always the solution for solving every problem.*"[77] In much the same spirit, former Director-General Moore noted that "*settlement ... is the key principle*," without which "it would be virtually impossible to maintain the delicate balance of international rights and obligations."[78]

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[74] Mavroidis 2000; Pauwelyn 2000.

[75] TN/DS/W/23, 3.

[76] TN/DS/W/23, 4.

Few long for a return to the power politics of the GATT era,[79] but it would be just as grave a mistake to overlook GATT-style diplomacy and fully embrace the WTO's greater legalism. Indeed, the importance of early settlement that is brought out in this chapter should inform the proposals penned for the Doha Development Agenda, as well as the very decision by Members to bring a case for WTO dispute settlement.

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[77] *International Trade Reporter*, 17 May 2001, 778. Emphasis added.

[78] Moore 2000.

[79] Barfield 2001.

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Intellectual Property Protection: Is it being taken too far?

Keith E. Maskus*

Introduction

The essentials of the debate about intellectual property protection have changed little since the establishment of the United States of America when the Founding Fathers debated the appropriate balance between creating incentives for creative endeavour and maintaining as large an information commons as possible. Time, changing economic circumstances and technological capabilities, and evolving political structures and vested interests have only weighed on the question of the means and the appropriate balance.

For a long time, this debate was carried out largely in the context of domestic policies. However, the centrality of technological innovation to economic growth in the last quarter century and the growing importance of the rents implicit in intellectual property protection to the bottom lines of multinational corporations and particularly to the international performance of the US economy combined to make the international extension of a high quality intellectual property regime a high priority of US trade policy during the Uruguay Round of multilateral trade negotiations.[1] The result was the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs)—and perhaps unprecedented controversy concerning the direction that international trade rule-making was taking.

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On the one hand, claims were advanced that strengthening patent regimes would lead to increases in growth-enhancing foreign direct investment, technology transfer and indeed in world trade. On the other hand, a range of concerns were voiced about the departure that TRIPs represented from established approaches to trade liberalization: the introduction of a rent-granting instrument into the corpus of international agreements (shifting rents from developing countries to developed and raising potential conflicts with competition policies); the shift from reciprocal liberalization in proportionate terms to a leap to a common standard (in good measure the US/EU standard) irrespective of potentially differing needs of nations at different stages of development; the shift from the GATT-era emphasis on what governments cannot do to what they must do; and the entrenchment in a potentially hard-to-change international agreement of specific regulatory standards that changing economic and technological circumstances might render suboptimal.

The claims seemed altogether exaggerated—on both sides of the debate. While credible arguments could be advanced that some nations would benefit from improved intellectual property regimes, many others lacked the pre-requisites for significant foreign investment and stood mainly to lose. At the same time, the intellectual property regime that was adopted in the WTO provided considerable flexibility in terms of compulsory licensing and left to individual members whether to regulate "parallel imports" of products with IPR protection in some jurisdictions but not in others, etc.. And there were other potential safeguards—not least the public relations problems that developed countries would face in seeking remedies in instances where developing countries might hold the moral high ground (e.g., where serious public health issues were at stake). Indeed, the WTO regime provided more flexibility than the US and European Union have been building into the intellectual property regimes embedded in the web of bilateral trade agreements that they have been developing in parallel with the WTO: for example, US agreements with Chile and Vietnam included what might be described as TRIPs-plus-plus levels of intellectual property protection; the same was the case with EU agreements with African/Middle East states. In view of the recently expanded appetite of the US for bilateral agreements, and given its centrality in the world economy, this is of considerable consequence for the effective global framework. Meanwhile, in the context of the World Intellectual Property Organization (WIPO), discussions were being mounted in respect of a patent harmonization treaty (PHT) which would also be a "harder" regime than that embodied in TRIPs and would provide less flexibility for less developed countries (excluding, for example, TRIPs carve-outs for "traditional knowledge").

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[1] The US had previously introduced intellectual property concerns, particularly with respect to counterfeit goods, in the last days of the Tokyo Round negotiations but the initiative did not become part of the agreement reached in 1979.

The various claims made regarding TRIPs invited empirical validation, fuelling a growth industry of literature on intellectual property. And then came the tough part: demonstrating empirically the relationships between intellectual property regimes and economic performance, domestically and in cross-country comparisons.

What is it that we know and don't know about these linkages? And, is an appropriate balance being struck between the use of IPR protection to stimulate innovation and creation and the expansion of benefits from the flow of information and ideas into the public domain (including by stimulating growth by imitation in the developing world)? In view of the heated debate surrounding the recent US Supreme Court decision turning down the challenge to the Sonny Bono Copyright Term Extension Act and the ongoing standoff on the interpretation of the TRIPs and public health initiative at Doha, the answers to these questions are of enormous consequence to public policy

Empirical research findings to date

Measurement issues

The first major challenge encountered by empiricists is to devise quantitative measures of intellectual property rights (IPR) protection. This is difficult in principle because, unlike a subsidy or tax which is measured, or a traded good to which the market assigns a value, the value of IPR protection is not directly observable (it is the difference in returns to innovators under two scenarios, one of which is an unobserved counterfactual). Indirect approaches are therefore necessary. One approach has been to construct indexes of patenting activity or trademark registrations on an aggregate national level.[2] This line of research continues to be developed, with an important direction being the extraction of information from patent data.[3]

A second approach is to develop measures of patent strength and of patenting cost based on features of the laws establishing and enforcing these rights. This approach has been taken by Walter Park. His mixed results indicate that the various types of intellectual property—patent rights, copyrights, trademark rights, software rights and parallel importation rights—must be looked at individually.[4]

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[2] For a survey of the early work based on patent statistics, see Zvi Griliches, "Patent Statistics as Economic Indicators: A Survey" *Journal of Economic Literature* Vol. XXVIII (December 1990): 1661-1707.

[3] For example, Professor Ajay Agrawal, Queen's University, is currently constructing a database to track patents referenced in corporate licensing agreements, specifically in Canada and the United States. Given concerns about confidentiality, license agreements are usually kept under lock and key, but their patent citations have to be disclosed, allowing examination of the flow of ideas across borders, and how companies are using them. Forthcoming as an NBER working paper by the spring of 2003

[4] Park found that patent protection and effective enforcement stimulate private R&D, albeit indirectly, and software rights had a positive but secondary effect on private R&D; however, copyrights, trademark rights and parallel importation rights generally had negative effects. See Walter G.

However, it is not clear that aggregate measures of IPR protection at the national level represent the best metric; given the differences across industries, more meaningful results might be derived from examining the effects of IPR protection on a sectoral basis. And, when cross-country comparisons are made, there is some evidence in support of the theory that IPR is in some sense endogenous to the political economy and stage of development of a particular country. For example, there appears to be a U-shaped relationship between patent protection and level of development with middle-income countries at the early stages of industrializing which grow by imitation tending to provide the weakest IPR protection. This suggests that the interpretation of the relationship between IPR protection and economic variables such as trade, investment and growth across countries may be subject to important caveats.

In view of these issues, it is perhaps not all that surprising that the empirical research to date has found effects flowing from IPR regimes to economic performance to be comparatively weak and in good measure indirect.

Distribution of Rents

The most controversial aspect of the TRIPs regime was the induced transfer of rents from developing countries to developed countries. Was TRIPs more about rent-seeking than about creating incentives for long-run growth?

One examination of this question looked at the value of patents held by residents of twenty-nine countries (which included a mix of developed and developing) in terms of the share of the present value of the rents implicit in those patents that came from other countries in this sample on both a pre-TRIPs and post-TRIPs basis.[5] While this study, by its design, could

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Park, "R&D, Spillovers, and Intellectual Property Rights", http://www.fundacion.uc3m.es/earie2002/papers/paper_211_20020320.pdf.

[5] See Phillip McCalman, "Reaping what you sow: an empirical analysis of international patent harmonization", *Journal of International Economics*, Volume 55, Issue 1, October 2001: 161-186.

not account for any increase in innovation stimulated by the implementation of TRIPs (or by the same token, any decline in growth through imitation that would also be implied by raising IPR protection in many countries), it did provide a measure of patent holders' gains due to the rise in the present value of the rents under patents filed in other members of this group. The study suggested that six countries (the US, Germany, France, Italy, Sweden and Switzerland) gained from patent harmonization under TRIPs, with the US by the far the biggest beneficiary (a net gain of US$ 4.6 billion in 1988 prices). Developing countries were losers as was to be expected; however, somewhat surprisingly, the largest loser was Canada, which was estimated to transfer about US$ 1 billion under patent rights held in 1988 due to TRIPs implementation.[6]

In 2002, the World Bank updated McCalman's study, applying his coefficients to 1995 data and converting the net patent rent shifts to 2000 prices.[7] It corroborated the finding that short-run rent transfers flowed primarily from developing and middle income countries to wealthier nations that hold the patents. Net gainers totalled US$ 41 billion with the US (US$ 19 billion), Germany (US$ 7 billion) and Japan (US$ 6 billion) gaining the most. The largest net losers were technology-importing industrial or industrializing countries, including Korea (US$ 15 billion), Greece (US$ 8 billion), China (US$ 5 billion) and Spain (US$ 5 billion). Canada came out on the debit side in this study as well although the amount was smaller than previously estimated (a net transfer of US$ 574 million), reflecting the strengthening of Canada's intellectual property regime in the early 1990s and thus the smaller incremental strengthening implied by the further move to the WTO-TRIPs level of protection. While the metrics behind these numbers are complex—meaning that the numbers should be taken with a huge grain of salt—they have become widely cited and have even served, quite tendentiously, as benchmarks for the possible shift of rents based on trademarks and copyrights (e.g., leading to claims such as that the transfers to the US amount to US$ "20+20+20" billion!).

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[6] This result reflected the great depth of the Canada-US economic relationship, the largest bilateral trading relationship in the global economy, and the extent to which Canada was a net importer of technology.

[7] See "Intellectual Property: Balancing Incentives with Competitive Access", Chapter 5 in World Bank, *Global Economic Prospects and the Developing Countries: Making Trade Work for the World's Poor*, Washington, D.C.: World Bank, 2002: 129-150.

One important result of this line of research is that TRIPs-induced transfers are shown to be potentially as large as the efficiency gains from trade identified in computable general equilibrium (CGE) model simulations, implying the possibility at least of overall losses to many nations in the short run from participation in multilateral trade liberalization—a fundamentally worrying result for an activity that is premised on win-win outcomes, even though the positive long-run benefits from trade liberalization continue to dominate any such short-term losses.[8]

Impact on trade, investment and growth

As noted, an important caveat concerning the above results is that they were based on static models and could not take into account the dynamic gains stemming from expected or actual increased innovation as a result of greater protection in the "net payer" countries, or dynamic losses from reduced growth through imitation.

A case has been made in the theoretical and empirical literature that strengthening IPR rights can increase trade and investment, including in higher technology products that could be important stimulants to technology transfer and thus to productivity growth.

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[8] For example, Mexico was identified as a country for which the TRIPs-induced transfers were sufficiently large to offset the gains from trade liberalization and thus implied an overall negative impact from the Uruguay Round in the short run; however, gains from trade tend to be larger in the long run and Mexico was shown to have a significant positive overall gain from the Uruguay Round. See Phillip McCalman, "Reaping what you sow: an empirical analysis of international patent harmonization", op cit., pg 181.

The economic literature on this issue, most of which is quite recent, suggests that multinational corporations would tend to be nervous about going into countries without strong patent protection for fear of leakage of technology. The result would be reluctance to: (a) export products that could be reverse-engineered or that "wear their secrets on their face"[9]; (b) license local firms to produce products or components embodying proprietary advanced technology; and/or (c) invest locally and train local personnel who might defect to local competitors, taking trade secrets with them.[10] The effect of such reluctance would be to reduce trade and investment flows from patent-holding countries to jurisdictions with weak patent protection.[11] Conversely, where IPR regimes are strengthened, multinationals would be expected to adjust and to transfer technology more readily.[12]

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[9] For example, in the case of seeds which enjoy plant breeders rights protection in some countries but not in others, multinationals might not trade with countries that have weak IPR regimes since the seeds can be reproduced by the importer.

[10] The seminal work in this regard is the research conducted by Edwin Mansfield based on interviews with executives of multinationals concerning their attitudes to trade and investment with countries with varying levels of IPR protection. He found that, in relatively high-technology industries like chemicals, pharmaceuticals, machinery, and electrical equipment, a country's system of intellectual property protection often had a significant effect on the amount and kinds of technology transfer and direct investment to that country. See: Edwin Mansfield, "Intellectual property protection, direct investment and technology transfer: Germany, Japan and the USA", International Finance Corporation Discussion Paper 27, Washington, D.C.

[11] A demonstration of such a reduction of trade and investment flows from the US to countries with weak IPR regimes, implying a reduced knowledge flow to such countries, is provided by Pamela J. Smith, "Are Weak Patent Rights a Barrier to U.S. Exports?" *Journal of International Economics* 48, 1999: 151-77; this study is updated and extended in Pamela J. Smith, "How do foreign patent rights affect U.S. exports, affiliate sales, and licenses?" *Journal of International Economics* 55 (2), 2001:411-439.

[12] This can be understood in economic terms as the result of a reduction in the cost of contracting. In developing country markets where there are many potential risks of leakage of technology, the cost of creating the

Depending on the circumstances of the country and the nature of the IPR regime, such dynamic effects can offset the static transfer of rents, potentially restoring a win-win dynamic from the inclusion of IPR in a trade regime. However, because circumstances in each case matter (whether it be in the context of a sector, a country or a region), it is a leap to accept that "stronger patent protection = increase in innovation and growth". The aforementioned World Bank study found that the major trade impacts were in countries with strong imitation capacities.[13] An excessive increase in patent protection could on balance have negative dynamic effects in countries such as these that have developed a technological capability to reverse engineer and imitate products with modern technology but are not yet at the stage where they can do true cutting edge innovation themselves (e.g., China and Brazil for the most part today, as were Korea and Japan in earlier decades). Such countries can benefit from appropriate levels of IPR protection that encourage adaptation of existing technology; but the optimal level of protection might be considerably less than required in technology-leading countries.[14] At the same time, it is not even totally clear that the developed countries would benefit in the long run: it has been suggested that lengthening and strengthening monopoly rights flowing from IPR protection could dampen the incentive to pursue new and risky innovation leading to a reduction in the steady state rate of innovation in the developed countries.[15]

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contract under which technology is transferred is high. This limits incentives to enter into such contractions. The TRIPs agreement lowers these costs and through this channel increases the propensity to enter into technology transfer contracts.

[13] See: World Bank, *op. cit.* pg 132.

[14] *Ibid.*, pg 134-135.

[15] A related issue is the rigor of the tests of novelty, specificity and practical application that are applied to patent applications. Low levels of rigor can expand the number of patents granted, increasing the costs of searching existing patents to avoid infringement and raising the risk of costly litigation, both of which could work to stifle innovation by small businesses.

The bottom line is that any positive impacts that are found from IPR protection are always conditional on contextual factors (e.g., market structure, number of local firms, existence of R&D activities in local firms, availability of human capital, etc.). Implementation of TRIPs standards of IPR thus may—or may not—lead to sufficient innovation to offset the combination of rent transfers and dynamic losses in terns of lower imitation-driven (and competition-intensifying) growth lost due to strengthened IPR protection. In the end, the only simple answer is the unhelpful: "it all depends—anything can happen."

Exhaustion of IPR and the issue of parallel imports

An important issue confronting intellectual property regimes from the standpoint of administrative complications in the management of international trade is that of parallel imports. This issue arises out of the fact that, within a country, intellectual property protection is said to be "exhausted" when a product that embodies intellectual property is sold for the first time. At this stage, the owner of the intellectual property has already extracted any rents implicit in that protection and the further resale of the product within the domestic market is not subject to restrictions. However, because owners of intellectual property may choose to exercise their monopoly power by price-discriminating between two markets (i.e., selling for a lower price abroad than at home), the possibility exists of those products being re-imported for sale in the domestic market (or between two foreign markets in which the product is priced differently). To prevent such arbitrage, countries may choose to deem that intellectual property rights are not "exhausted" when products are exported; accordingly, subsequent cross-country arbitrage ("parallel imports") would be subject to restriction.

Economists tend to pay little attention to how products are distributed (i.e., whether through licensing arrangements, through the intermediation of wholesale/retail networks etc.). More than half of all products sold are through intermediaries, effectively precluding arbitrage by the end consumer. However, the scope is opened up for arbitrage trade at the wholesale level. This is a particular issue in the EU, where internal trade is unrestricted but the principle of subsidiarity permits the emergence of differing price regulations in the various member states. Parallel importers can exploit this situation by seeking out pockets of excess supply of a regulated product for ultimate distribution in a higher-price jurisdiction.[16]

The parallel import issue is not resolved through patent harmonization since it is driven by differences in monopoly pricing power in different jurisdictions. This points to ongoing administrative complications from the doctrine of non-exhaustion of intellectual property when products embodying intellectual property are traded internationally.

Tentative Conclusions

The importance of intellectual property to current US trade policy cannot be understated. And, given the importance of the US as a destination for international exports and the range of tools that the US has for influencing its trading partners (e.g., tying patent enforcement to access to US development assistance or developing country trade preferences, the threat of trade sanctions such as section 301, super 301, etc.), it is likely that a high quality intellectual property regime will continue to be part of the system of international trade rules.[17] Accordingly, the boilerplate conclusion that more research is needed surely applies in this case. Such research will be helped significantly by World Bank survey data, which is just now becoming available.

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[16] For a discussion, see Mattias Ganslandt and Keith E. Maskus, "Parallel Imports of Pharmaceutical Products in the European Union", unpublished manuscript, September 15th, 2000.

[17] Korea is an example of the effectiveness of these various pressures: in 1988, major reforms of the patent system took place under enormous U.S. pressure, despite very little support for the move domestically. Since, Korea's intellectual property rules have been heavily enforced. Korea has some innovation capacity, but most of that is concentrated in a handful of firms: 5 major firms in Korea register over 80 percent of the domestic patents, with Samsung alone accounting for over 50 percent. It appears that the patent system was only taken up by the multinationals that must play in the US market. Meanwhile, Korea is paying significant sums to import foreign technology.

Overall, it is hard to conclude otherwise than that strengthening IPR regimes is detrimental to the economic interests of the less developed and many if not most middle income countries as well as even some highly developed technology-importing countries (Canada being a prime example). For the less developed, the effects are almost uniformly negative—increased transfer of rents to the technology exporters, less growth by imitation and no real prospects that these losses can be offset by innovation-induced growth.

Middle-income countries have better prospects to eventually benefit from improved IPR regimes. Over the long term, some of these countries (like India, China) stand to benefit. At the same time, in the short term, change of IPR regime can shut down industries that are thriving on the basis of imitation. The experience in Thailand indicates that some imitating industries adapted but others were pushed out of business.

Is it possible to overdo IPR protection? The answer is certainly yes. In countries such as the US, where IPR protection is the strongest, there is a clear risk of over-extending protection to the detriment of competition and consumer welfare and, most generally, to the flow of information and ideas into the public domain.[18] The emphasis on patenting in the universities may also have the unwelcome side effect of reducing the quality of research with longer-run implications for the pace of fundamental innovation.

Finally, there is cause for some concern about the ultimate effectiveness of a patent regime that is in good measure imposed upon a country by external forces (i.e., by disciplines embedded in WIPO, TRIPs, U.S. trade policy etc.) rather than adopted out of self-interest.

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[18] The public good aspect of research and the questions surrounding the extent to which IPR protection in slowing the flow of ideas into the public domain and the implications of this for external innovation will be explored at the conference, "International Public Goods and Transfer of Technology after TRIPS" April 4-6, 2003 at Duke University.

TRIPs is receiving sufficient criticism from so many quarters that it probably is not sustainable in its present form, although the shape of a sustainable international intellectual property regime is also not clear—issues range from the question of term of patent protection (there is no reason to believe that the 20-year term of patent protection, which goes back to the first known patent, a 1449 grant of a glass-making monopoly in England, is optimal in the context of modern technological developments) to the question of breadth of coverage (e.g., as the controversies over patenting life forms show). At the same time, apart from pharmaceuticals, which are the front line of the battle over TRIPs and where its problematic aspects are perhaps most significant, the magnitude of its negative effects should not be exaggerated. There are reasonable grounds for some optimism that TRIPs is flexible enough to allow the more difficult problems raised by intellectual property harmonisation to be handled in one fashion or another.

Part III:

The Social Dimensions of Globalization

The Social Dimensions of Globalization: Some Commentaries on Social Choice and Convergence

Dan Ciuriak and Charles M. Gastle[*]

The idealistic vision (and implicit promise) of globalization as promoted by international economic diplomacy is a chance for quality of life for all, with opportunity for education and "decent" jobs, access to basic health care and, respecting differences across nations, some measure of control over one's life, environment and culture, including through political empowerment. With varying depth of conviction and widely varying degrees of success, most nations have accepted the invitation to "go global" and all which that entails:[1] trade and investment liberalization, acceptance of the disciplines of international rules and adjustment of domestic policies to meet the demands of the rough and tumble of today's global economy.

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[1] Even Africa is not rejecting globalization. At the World Commission on the Social Dimension of Globalization (WCSDG) regional dialogue in Arusha, Tanzania on February 6-7, 2003, where it was emphasized that Africa has not benefited from globalization and is being left behind, the emphasis was not on rejection of globalization but rather on reforms—African and systemic—that would allow Africa to become a full participant.

But as globalization has progressed so has the controversy surrounding it. Unfortunately the debate about globalization is, almost hopelessly confused due to its many cross-currents. In part that reflects the fact that it is as much about the actual state of the world as it is about the "forces" that have shaped it. Characterizations of the globalized economy from the "glass half empty" crowd vie for public attention with those from their optimistic opposites. The assessments could hardly be more different. Advocates credit it for everything from gains from trade and scientific progress to progressive democratization of the world's political entities. Critics use it as a whipping boy for all the world's ills. Some bemoan the intrusions of global systems into domestic spheres. Others who acknowledge constraints on social choice from globalization argue, however, that the constraints are all to the good, eliminating bad choices and countering the domestic power of entrenched interests—in effect, leveling up. Others see exactly the same dynamic as an imposition of a particular set of social preferences, and not an especially desirable set—in effect, leveling down. And all without democratic legitimacy.

While the temperature of the debate in research circles is cooler, the results are not necessarily all that much more illuminating. In various areas of international economics, research has turned up puzzles galore about the way the globalized economy works:

- Despite a massive expansion of international trade and investment, border effects were found to be surprisingly high and economies much less tightly coupled than expected.
- Thinking about the role of capital in development has had to be quite radically revised—not least because the direction of net flows turned out surprisingly to not accord with expectations.
- Not unrelated to the preceding point, theories about income convergence internationally (factor price convergence, etc.) have had to be adjusted (from convergence, to conditional

convergence, and most recently to polarization as per the "twin peaks" school).

- Opinions about the economic performance of nations and regions have been even more radically revised (East Asia pre- and post-crisis, Japan 1980s vs. 1990s, reforming Latin America pre- and post-Russian default); crisis models were revised, an arcane theory (the liquidity trap) drawn from closed economy models was dusted off and applied (unconvincingly) in an open capital market context, and poster boys of globalization of one year were pilloried for their failings the next.
- Exchange rates, the most important prices in a globalized economy, have generated their own puzzles. They have strayed from purchasing power parities for puzzlingly long periods, made sharp discontinuous shifts, which some have attempted (also less than convincingly) to explain with theories of multiple equilibria, and the dollar-yen-euro/d-mark triumvirate has traced patterns that have defied adequate explanation.

These puzzles have contributed to continuous evolution of opinion concerning way the global economy works. Along the way, there has been a progressive shift of policy emphasis from standard macroeconomic determinants of economic performance (inflation, budget deficits, etc.), to microeconomic frameworks (privatization, incentives to work, etc.) to institutional frameworks (enforcement of contracts, entrenchment of property rights, etc.), to "ownership" of reforms (code language for political commitment). Rolled up into the "Washington Consensus", this has become a template for reforms and development worldwide, and at times a template for conditions for bailout loans from the International Monetary Fund (IMF)—and a lightning rod for criticism.

The most recent shift, one that appears to be still emerging is towards income distribution as an increasingly important issue—as reflected, *inter alia,* through the formation of the *World Commission on the Social Dimensions of Globalization* which was launched 27 February 2002 under the aegis of the International Labor Organization (ILO)[2]—and as a solution: John Williamson has recently updated the Washington Consensus policy package to include attention to income distribution.

The renewed interest in distributional issues provides the motivation for the essays in this chapter. In the rich industrialized countries, these issues fall under the general rubric of preserving social choice and implicit social contracts in the context of evolving systems of global governance and the competitive pressures of the global economy. In the poor countries, they fall under the rubric of raising income levels, i.e., convergence. Of particular interest is the trade-off between social choice for the rich and convergence for the poor that implicitly informs much of the debate over globalization. Does it exist? If so, how powerful is it? And if it is weak, why?

These issues are explored through five essays. To provide the usual roadmap, the first two essays take up issues pertaining largely to the rich countries, the following two address related issues in the developing world, and the fifth suggests a systemic issue that helps explain the results identified in the first four.

First, we consider the extent to which globalization impinges on the ability of a nation state to make its own social policy choices given the emergence of a system of global governance with trade rules that reach into the domestic policy sphere. The impingement of sovereignty is at the heart of a significant cross-section of the debate about globalization and the distributional questions internal to nation states.

Second, we consider a closely related question, namely the extent to which the nation-state can preserve the implicit social contracts that have evolved in market economies, not because of the impingement of international rules but because of international competition, including, for example, in rule-making to attract investment.

Third, we briefly consider the difference that being poor makes when it comes to interfacing with the system of global governance. The system that applies to developing countries was not created with their circumstances in mind and the evolutionary *ad hoc* way in which it has come to apply to them does not provide them with the collective economic security that it provides for the rich.

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[2] International Labour Organization "ILO Tackles Social Consequences of Globalization" www.ilo.org/public/English/burearu/inf/pr/2002/6.htm

Fourth, we consider the results that have emerged from the research into the distributional inequality across nations, and particularly into the question of why trade and investment have not consistently led to convergence in line with original expectations of economists.

Fifth, shifting the focus to contextual factors, we remark on the episodic nature of convergence: in particular, the differences between pre- and post-1870 experience, and between Bretton Woods-era and post-Bretton Woods experience. We consider the role in explaining this temporal pattern that may be attributed to the behaviour of prices in transmitting information under the alternative exchange rate *regimes* that characterized these sub-periods of the two great eras of globalization of the past two centuries.

The present essay now proceeds to summarize the main conclusions.

Social Choice for the Rich, Convergence for the Poor

Implicit in the idealized vision of globalization is a vast transformation of social structures, much more so of course in the countries still seeking to create modern industrialized economies than in those that created the model. Yet, even in the latter, stresses on social frameworks are to be expected, at least during the transition to a global economy in which most states are industrial.

In the best of all globalizing worlds, the rich would get richer but the poor would get richer even faster. The result would be sustained convergence of per capita incomes worldwide. At the same time the rich countries would be able to maintain social policy preferences in the face of the economic pressures generated by the competitive challenge of the industrializing poor, in part because the rapidly converging poor would begin to acquire similar social preferences (as commonly argued, these would include increased demand for a clean environment, high standards of safety for workers, strengthened social security, etc.).

This might be too much to reasonably hope for. The establishment of global governance regimes to facilitate trade and investment might constrain the range of choices available to participants of the globalized economy, reducing social choice considerably. It might also be the case that the price of convergence for the poor would be further erosion of social choice for the rich. Capital mobility has often been argued to provide a plausible connection between these two dynamics. For example, if the flow of capital from rich countries to poor were sufficiently powerful to drive convergence, the threat of capital outflow might also reduce the bargaining power of rich country wage earners, shift rich country tax burdens in a regressive direction (e.g., towards consumption taxes and away from progressive income and capital taxes), and undercut the ability of the rich countries to impose socially motivated regulation.

But we ought to be able to do better than the worst of all globalizing worlds, in which we do not see convergence for the poor but do experience erosion of social choice for the rich. Yet, for many critics of globalization, this is in fact today's reality: constraints on social choice in the rich countries but developmental failure in the poor despite trade and investment liberalization.

How do we conclude?

All things considered, for rich countries, the scope to address distributional issues has not been reduced significantly by globalization. Trade rules do reach into domestic policy space; but the contractual nature of trade agreements, the deliberate pace of trade negotiations, and the essentially diplomatic character of dispute resolution, all mitigate the erosion of social choice in *de facto* and *de jure* terms. Insofar as trade is in part responsible for prosperity, the expansion of social choice afforded by expanded means would tend to offset any such erosion, although this would tend to be less obvious than the instances of impingement. Other aspects of global governance (the international financial regime) do not weigh heavily on the rich since the rules are basically distillations of their common experience—if they are constraints, they are constraints against which the rich do not rub.

That being said, the appeal of ideas that seem to work in some places can lead to convergence, not through pressure but through the attraction. The globalization of ideas is perhaps given inadequate responsibility for observed trends. At the same time, the de facto preservation of scope for social choice in the rich countries may rest on the factors that have resulted in the puzzling degree of modularity of economies. In other words, in models of globalization that feature less modularity, it cannot be presumed that such scope for social choice would necessarily prevail.

The story for the developing countries is quite different. For many developing countries, the social choice framework fits poorly. The essential features of representative government, capacity to make informed choice, and wherewithal to provide the social insurance embodied in the idea of the social contract are often missing. The major impact on domestic policies does not come through the system of trade rules. This reflects both *de jure* special and differential measures and the *de facto* softness of the constraints of trade commitments implied by weak implementation on the one hand and non-enforcement by trading partners on the other. "Leveling up" pressures on social policy frameworks from the threat of trade protectionism appear to be no more effective in practical terms than the "leveling down" pressures on rich countries from capital mobility.

The major impact of international governance on developing countries comes through the international financial system. As a result of the proliferation of failed states and financial crises over the past several decades, developing countries have all too often found themselves in the hands of their creditors—and thus effectively under the tutelage of the international financial institutions, which have actively used conditional provision of financing to leverage changes in domestic policy frameworks in a manner far more intrusive than the system of trade rules. Conditions imposed on bailout loans do bite and have impacted on the ability of developing countries to maintain social policies. Given that emergency loans might not be forthcoming under *any* conditions, and given that the alternative to obtaining a loan with conditions can be even more disruptive (i.e., *not* receiving emergency loans), it becomes clear that, as with many things in life, the aspiration to preserve social choice under globalization is largely a privilege of the rich. The reality is that there is no social obligation across borders for purely economic pressures to parallel the social contracts within nation states. The developing countries thus participate in the globalized economy without any real semblance of collective economic security; prudent policy thus suggests globalizing on a "safety first" basis.

Of course, all this would be largely forgiven if there was convergence—legitimacy is after all ultimately a function of success. Unfortunately, many countries and indeed whole regions have recently been *departing* the "convergence club". While the developmental successes of China and India are very important offsets, the long and the short of it is that developing countries have had, by and large, neither social choice nor a significant closing of the income gap with the developed countries.

Reviewing the literature, it becomes clear that convergence is not likely to be mainly a story about large volumes of capital flowing from rich countries to the poor. Where foreign direct investment brings a missing bit of the puzzle, its catalytic effect can be huge. But this is a far more subtle story than factories in rich countries being shipped to poor countries and driving wages to equality. The latter effect is not entirely absent from the picture, but it is also clearly not central to the story of convergence or lack thereof. This is one reason why the trade-off between social choice in the rich countries and convergence in the poor has been weaker than expected (or feared).

Yet in the poor countries as in the rich, this feature of today's version of globalization rests to an important extent on puzzles. The fact that an "increasing returns" story *can* explain why capital would flow to rich countries does not simultaneously explain why this effect should *dominate* the "decreasing returns" story that explains convergence under other circumstances (e.g., within national borders). One can acknowledge the "increasing returns" story without accepting it as a full explanation of actual patterns of convergence.

The convergence literature has tended to focus on factors intrinsic to individual countries. For example, the theory of "conditional convergence" asserts that a complex set of national characteristics determines different levels of potential incomes towards which these nations "converge", even though they might diverge across the broad spectrum of the rich and poor. The implication is that changing the explanatory variables—i.e., improving the characteristics—will raise the level of income towards which the poor "converge". However, the revealed difficulty of turning stylized facts about successful economies into a growth prescription for the poor causes one to question what is explaining what. And thinking continues to evolve: reportedly, the "twin peaks" theory, which posits polarization of income levels, has been gaining adherents. The field remains open to competing hypotheses.

In addressing this question, we are prompted by the episodic nature of convergence (i.e., the inconsistency of the convergence record over time) to shift the focus from the intrinsic to the contextual and to consider whether it is possible to identify systemic factors that make development more likely.

Overall, the historical record of the two great eras of globalization (from the end of the Napoleonic wars to WWI and from the end of WWII to the present) suggests that countries were much more likely to join the "convergence club" after 1870 than prior to that date; and prior to the 1970s than afterwards; indeed, during the latter era, there was a widespread *departure* from the convergence club. While important technological advances (steamship and telegraph) are sometimes credited with stimulating convergence in the 1870s, a similar acceleration of technology in the latter part of the 20th Century (including a vast expansion of commercial jet travel and the information technology revolution which combined to spell the "death of distance") was associated with exactly the opposite effect.

One point of symmetry stands out: almost exactly a century apart, two events changed the international monetary order. In 1871, Germany's switch to the gold standard following its success in the Franco-Prussian war, set off a chain reaction leading to the establishment of the international gold standard that prevailed until the beginning of WWI. In 1971, the United States abandoned gold convertibility of the dollar, spelling the end of the Bretton Woods arrangements. The rule "rigid numeraire → convergence" explains the pattern, whereas the rule "technological reduction of distance → convergence" fails. Convergence across large economic units featuring common currencies or reasonably hard exchange rate regimes—American states, Japanese prefectures and Euro states—is consistent with the episodic historical story.

In other words, the global *monetary order*[3]—or political economy factors for which regime choice proxies—seems to matter quite a bit. This in turn points us to examine price behaviour. If economic agents—individuals, corporations and governments—respond to incentives, as can plausibly be argued, and if information on incentives is coded in prices, then a global regime that gives truer information concerning "equilibrium" values of relative prices will guide economic agents to make wiser choices. Conversely, misleading price signals can lead to mistakes, and a compelling story can be told concerning the frequency with which such mistakes were made as a result of the surge of commodity prices that accompanied the flotation of the dollar. The resulting windfall benefits prompted rent-seeking behaviour that spawned friction, financial over-extension that led to crises and generally unsustainable (in the original sense of this word) patterns of industrial development—and not just in the developing world.

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[3] The concept of a "monetary order" which has been proposed by David Laidler encompasses not only the monetary/exchange rate regimes, but the supporting and underlying institutions, public expectations, etc., that go along with it. For further discussion, see David Laidler, "Inflation Targets versus International monetary Integration: A Canadian Perspective", CESifo Working Paper No. 773, CESifo, Munich, Germany, September 2002. www.ssc.uwo.ca/economics/centres/epri/wp2002/Laidler03.pdf

The great anti-inflation battle of the 1980s was waged on the premise that stability of the price level was important for the efficient transmission of the information content in prices at the domestic level. This interpretation of the historical record suggests that the efficient transmission of the information content in prices *internationally* is an important factor in the expansion of the convergence club—and preventing large-scale departures as witnessed in the last several decades.

Since exchange rate regimes appear to be particular to the political/economic/security circumstances which spawn them, it is not self-evident what are the realistic alternatives to the current "non-system" which features an untethered fiat currency as numeraire. Consideration of this question is well beyond the scope of this paper. However, insofar as many of the problems associated with globalization are arguably endogenous reactions to the behaviour of prices under the current system, these results do bear on the policy focus on what are then seen as merely symptoms (e.g., the anti-corruption campaign).

Further, there is an interesting twist here: insofar as the high degree of modularity of economies is partly explained by unstable international price behaviour, the tighter coupling of economies that would arguably drive greater convergence would also likely exert greater pressure on domestic price structures and by extension on the social choice frameworks which are partly their determinants. In other words, in a world in which we see more convergence, there might indeed be more of a tradeoff posed for the rich countries—to which it is not clear how they would respond. As Barry Eichengreen has argued, the difficulty of maintaining the gold standard in the interwar period reflected the changed socio-political circumstances that prevailed following WWI.[4] Thus, causation does not flow simply from monetary regimes to social frameworks but also vice versa.

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[4] Eichengreen argues that universal male suffrage and the emergence of labour parties to provide political representation to workers undermined the political insulation of central banks that was critical to maintaining the credibility of gold convertibility in a world of shortage of gold reserves. The shifting of political consensus towards a full-employment objective was incompatible with the periodic deflations required under the gold standard when reserves ran low. In the US, the political weight in the Senate of states

Whether globalization is the "enormous, inevitable and irreversible" international force[5] that many fear, or a spent force whose "best use by" date passed when the World Trade Centre collapsed, marking what may in retrospect turn out to be the passing of yet another "golden age", the only thing that is clear about it is that is enormously complex and stimulates commensurately complex reactions. Hopefully the following essays will shed some light on some of the distributional issues that appear to be gaining in prominence in the general debate.

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with important farm sectors also militated against deflationary policies since farmers were particularly hurt by falling prices which made servicing their nominal debts all the harder. See Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: Princeton University Press, 1996).

[5] As described by John Ralston Saul, op cit.

Sovereignty & Social Choice under the Rules-Based Multilateral System

The issue of freedom of policy choice in the domestic sphere under globalization can be addressed in terms of the concept of sovereignty, the essential feature of which is the implied absence of *external* constraints on the choices that nation states make concerning social arrangements within their own borders.[1]

The range of feasible social policies that are available to nation-states may of course be constrained without sovereignty being impinged. For example, insofar as nation-states make particular choices concerning organization of their economies, the feasible set of social policies is invariably affected—the inevitable consequence of moving out along a decision tree. The mere choice of one alternative, together with the passage of time, limits the choices that are later available. Good economic choices can expand the capacity of a society to undertake activities such as universal health care or education (this is the equivalent of moving out along a big branch replete with possible further choices); conversely, bad economic choices can obviously diminish such capacity.

At the same time, particular *economic* policy choices can constrain the approaches that can be taken to achieve particular *social* objectives. For example, public sector provision of health care permits simple universal access to health facilities while a private sector mode would likely require some form of subsidy of low-income earners to ensure universal access. The ultimate social policy objective remains feasible, but the mode of delivery may be constrained by the form of economic organization. And obviously, society will not necessarily be indifferent to the mode of delivery, implying feedback from social objectives to economic policy choices.

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[1] See: Kenneth J. Arrow, *Social Choice and Individual Values*, Second Edition, 1963, Yale University Press, at 28, 30, 31

International Trade Rules: Implications for Social Choice

International trade unambiguously expands the economic choices available to any nation state—for small countries, the expansion is significant.[2] Insofar as a country *chooses* to engage in international trade and to offer market access at home in exchange for market access abroad—entering into, for example, the contractual arrangements embodied in the World Trade Organization's (WTO's) single undertaking—there is obviously no impingement on sovereignty, even though, as with any economic choice, there will likely be clear-cut constraints imposed on the *subsequent* range of social policy options.

The role of supra-national governance regimes in establishing international norms and standards also clearly acts to constrain the range of further choices available to all participants in the international economy. As in the case of domestic economic policies, good standards work to expand further choices by facilitating global economic progress, and bad standards diminish such further choice.

What happens if a particular international standard chosen is considered bad from the perspective of one nation? As a practical matter, the cost to the country of *not* accepting the undesired standard may be considerably higher than the cost of accepting. And so it accepts. Has its sovereignty been affected—has, in other words, a choice been "forced" on it (in the sense of diminishing its sovereignty)? The answer is surely no: its decision remains a sovereign one even if the terms of international engagement have gotten worse.[3]

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[2] The easy way to appreciate this is to consider that the export of particular goods and services to earn foreign exchange that is used to purchase imports is an alternative "technique" to produce those imports. Engagement in trade thus unequivocally expands the production possibilities available to a nation. The smaller the nation, the less scope it has to produce a wide array of products efficiently; hence the greater the expansion of production possibilities implied by trade.

[3] The situation discussed here is to be distinguished from that in the international domain where treaties shaped under conditions of asymmetrical power, as well as international rules, norms, and procedures that serve as a

If conversely a country does not like a rule (or, for that matter, a particular ruling of the WTO's Dispute Settlement Body) and chooses *not* to comply, it should accept with equanimity the withdrawal of the benefits that it enjoyed under the bargain it now rejects.

While national choices (including international bargains entered into) may at times be ill advised and while some decisions of supra-national bodies may be lamentable, such choices and decisions do not raise basic problems as regards the model of globalization, at least not in the dimension of sovereignty.

The Impact of the WTO Agreements

Historically, the multilateral system has mainly relied on two principles to prevent discrimination against foreign products in domestic markets: the principle of "most favoured nation" and that of "national treatment". Neither principle speaks to the nature of domestic rules; both simply require that the same rules that apply to domestic products apply also to imports from all members of the multilateral system. These principles are inherently structured so as *not* to drive domestic policy convergence.

However, over the course of successive trade rounds, trade rules started to go beyond these principles and to reach beyond tariffs to address "inside the border" measures that had trade implications.[4] The major innovations came with the Uruguay Round which introduced the Agreement on Trade-Related As-

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counter-balance to asymmetrical power, constrain state behaviour. The game theory literature on games between players with asymmetric power suggests that, in institutional contexts such as the WTO, bilateral and plurilateral coalition building, partnerships and joint ventures between both state and private sector actors will also emerge as a partial counterbalance. See, for example, Bernard Hoekman and Michel Kostecki, *The Political Economy of the World Trading System: From GATT to WTO* (Oxford: Oxford University Press, 1995); especially Chapter 3.

[4] One result was the "legalization" of the GATT; the multilateral system took a major step in this direction in the Tokyo Round. See Sylvia Ostry, "Reinforcing the WTO", 1998 Occasional Paper 56, Group of Thirty, Washington. Available at www.utoronto.ca/cis/wtogp30.pdf, pg 7.

pects of Intellectual Property (TRIPs), the General Agreement on Trade in Services (GATS), and the strengthened Dispute Settlement Understanding (DSU). Individually, and through their interaction, these innovations extended the jurisdiction of WTO dispute settlement to domestic regulation in an unprecedented fashion;[5] in the view of some, this extension was made without adequate analytical preparation and thus with unintended consequences.[6]

GATS reaches inside the border because it applies to services trade through "Mode 3" or "commercial presence"—that is to say, services delivered in a country by an office of a foreign company. Since the provision of services is typically subject to regulation, the opening up of a service sector to trade exposes these regulations to challenge under the WTO's dispute settlement system. That being said, since the design of the GATS allows countries to pick and choose which sectors they open up, a choice that is subject to domestic political pressures, the impact of multilateral disciplines on domestic rule-making in this area remains largely in the "potential" category.[7]

By contrast, the TRIPs agreement is part of the single undertaking; accordingly every WTO member is required to enact certain existing international conventions into domestic law.[8] While the intellectual property laws are primarily of an economic nature, their application can impact any area in which intellectual property can arise, from medicine to art. Accordingly, they have potentially wide ripple effects in the social policy sphere. Signing onto TRIPs is the quintessential example of a choice made by signatories to the WTO's single undertaking that narrowed subsequent social choices in exchange for what were presumably greater benefits in other domains.[9]

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[5] See William A. Dymond and Michael M. Hart, "Post-Modern Trade Policy: Reflections on the Challenges to Multilateral Trade Negotiations after Seattle," *Journal of World Trade* 34 (3): 21-38, 2000.

[6] For a discussion bearing on this point, see John M. Curtis and Dan Ciuriak "Towards Half Time in the Doha Development Agenda", Chapter 1 in the present volume, at pg 11

[7] For a detailed discussion of the considerations bearing on trade liberalization in the sensitive health services sector, see Jake Vellinga "International Trade, Health Systems and Services: A Health Policy Perspective" in *Trade Policy Research 2001* (Ottawa: Department of Foreign Affairs and International Trade, 2001): 135-185. The complexity of the issues facing services trade negotiators in grappling with the interface with domestic regulatory frameworks, a factor that works to slow the pace of negotiations, is brought out in John M. Curtis and Dan Ciuriak "Towards Half Time in the Doha Development Agenda", Chapter 1 in the present volume at pg 24-30.

Given the controversy over the radical departure in WTO rule-making that TRIPs represented, it is not clear whether it signals the future direction of multilateral rule-making or will prove to be an isolated case. Thus, while the introduction of labour and/or environmental standards into the body of WTO agreements has been strongly resisted, this model has been discussed in the context of the debate over how competition law principles might be included.[10]

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[8] TRIPs Article 1(3) provides: "Members shall accord the treatment provided for in this Agreement to the nationals of other Members. In respect of the relevant intellectual property right, the nationals of other Members shall be understood as those natural or legal persons that would meet the criteria for eligibility for protection provided for in the Paris Convention (1967), the Berne Convention (1971), the Rome Convention and the Treaty on Intellectual Property in Respect of Integrated Circuits, were all Members of the WTO members of those Conventions."

[9] The term "presumably" is generous since we are only at the beginning of the road in understanding the implications of intellectual property regimes. For example, see Keith E. Maskus "Intellectual Property Protection: Is it being taken too far?", Chapter 6 in the present volume.

[10] For example, international competition law principles might be established through harmonization on the basis of reciprocity or by agreement on minimum competition law standards, which contracting parties would be required to include in their domestic codes. The standards might be fully defined in a model code or contracting parties might be given scope to craft their own statutory provisions based on the general principles set forth in the plurilateral agreement. The draft International Antitrust Code that was released in 1993 is an example of the latter alternative. For a full discussion, see Charles M. Gastle, "The Convergence Of International Trade And Competition Law Through A WTO Market Access Code", *Currents: International Trade Law Journal* (associated with Texas A&M University),

The WTO dispute settlement understanding (DSU) has also sometimes been identified as a mechanism that could drive social policy convergence, although here it is important to distinguish the contextual vs. the intrinsic, the *de jure* vs. the *de facto* and reality vs. the untested hypothetical.

Context is clearly important: if substantive WTO disciplines did not reach inside the border, neither would the DSU's influence—that is, there is no *intrinsic* in-reach from the DSU. However, because specific agreements do reach in, the possibility is created for the WTO's Dispute Settlement Body (DSB) to rule on substantive provisions of domestic regulatory frameworks.

In *de jure* terms, the DSU significantly strengthened the dispute settlement system compared to the GATT. The trappings of a legal system were created with the introduction of the Appellate Body and the establishment of legalistic procedures.[11] The automatic adoption of panel reports raised the risk of remedies being applied.[12] At the same time, procedures were established to make implementation of recommendations of the Dispute Settlement Body (DSB) more likely.[13]

(Winter 1999); and Karl M. Meessen, *Competition of Competition Laws*, Northwestern Journal of International Law and Business (1989): 17-30.

[11] For a description of the changes wrought to the dispute settlement system by the reforms in the Dispute Settlement Understanding agreed in the Uruguay Round, including in terms of indicators of legitimacy (including determinacy, symbolic validation, coherence and adherence) see Debra P. Steger "The Struggle for Legitimacy in the WTO", Chapter 4 in this volume.

[12] That being said, retaliation is seen as the last resort: the DSU states that its first objective is to "secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any covered agreement." *WTO Understanding on Dispute Settlement*, Article 3.7. Most cases are settled and it is unusual for retaliation to actually be taken (for a discussion of early settlement in the GATT/WTO, see Marc L. Busch and Eric Reinhardt, "The Evolution of GATT/WTO Dispute Settlement", Chapter 5 in the present volume).

[13] Following a panel determination that a measure is inconsistent with obligations under a WTO-covered agreement, the respondent is required to report to a Dispute Settlement Body meeting held within 30 days after the

While the DSU has the "look and feel" of a legal system, it nonetheless lacks the key feature of a remedy that is both binding and enforceable as this term is understood in domestic judicial systems. Unlike in domestic law where sanctions of a punitive nature can be imposed, the trade system can only create choices that are sufficiently attractive to induce states to eschew particular courses of action as the price of admission to the bargain. Thus, the DSU *recommends*, and does not *order*, compliance with a member's *own WTO commitments* and not WTO *law*; and it authorizes aggrieved parties to merely *suspend benefits* rather than allowing the imposition of *sanctions*. These are not semantic distinctions: a nation that wishes not to be bound by the TRIPs provisions can choose to not comply and, as noted earlier, suffer the withdrawal of concessions made to it by any WTO members that challenge it through the DSU, win their case and are authorized to suspend concessions to a specified degree. There are consequences but there is not, in a literal sense, enforcement.

In *de facto* terms, we are faced with the issue of criteria: how are we to judge whether the decisions coming down from the DSB in some sense show deference to members' social policies? Implicitly, if rulings "show deference", they are not taken strictly on their legal merits. If there is a clear preponderance of pro-plaintiff rulings, does this reflect a pro-trade liberalizing philosophy or the fact that plaintiffs tend to plead only those cases that have a high probability of success (i.e., plaintiffs might be reluctant to dispute culturally or socially sensitive measures, anticipating that the DSB will have a predisposition to the defendant given the politics)? In this area it is almost in-

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adoption of the panel or appellate report as to its intentions with respect to the implementation of the panel recommendations and rulings. *WTO Understanding on Dispute Settlement*, Article 21.3. The respondent will be given a "reasonable time" to implement changes the duration of which will be determined through binding arbitration within 90 days if the parties cannot otherwise agree. Arbitration is also available under Article 21.5 should the parties disagree "as to the existence or consistency with a covered agreement of measures taken to comply."

escapable that the final assessment will reflect as much the perspective of the analyst as the actual record itself. That being said, it is interesting to observe that the DSB has favourably cited and, in the view of some expansively interpreted, Article XX, which provides exemptions for policies inconsistent with members' obligations, which are undertaken for pressing social or other needs.

It is important to note in connection with the functioning of the DSU, that it can influence social policy choice indirectly by making reference to external codes—and by the same token change the character of those codes. For example, adherence to guidelines issued by the Codex Alimentarius Commission, while voluntary in and of itself, serves as the basis for a defence in the event that a domestic standard is challenged under the WTO's Sanitary and Phytosanitary Agreement (SPS). Voluntary standards thus become, in effect, necessary—"volunteerism under duress" as it has been termed.[14]

Such reference to external codes can work either as a "levelling up" influence (countries increasing their standards to avoid challenge under the WTO) or "levelling down" if standards higher than set out in the external code are successfully challenged—although only if the defendant complies.[15] Where higher standards are adopted by important economic jurisdictions (and suitably defended on the basis of scientific evidence—e.g., Articles 3 and 5 of the SPS Agreement allow members to maintain higher standards than are allowed under Codex), this can cause a *California Effect*, as other countries raise their standards above the Codex standard to match or exceed the market leader. Thus, there is no necessity of "levelling down", but this is clearly context-dependent.

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[14] Aaron Cosbey, "A Forced Evolution?: The Codex Alimentarius Commission, Scientific Uncertainty and the Precautionary Principle", International Institute for Sustainable Development (2000), www.iisd.org/pdf/forced_evolution_codex.pdf at pg 8-9

[15] For example, in the WTO Case *Hormones*, the EU argued that its ban on imported beef was based on the precautionary principle, but could not demonstrate that its measures were based on a risk assessment in accordance with Article 5 of the SPS Agreement). The DSB found against the EU but the EU did not comply, accepting withdrawal of concession by the complainants instead.

As a final observation in this connection, the WTO *Brazil-Aircraft* dispute demonstrates the way in which an international agreement (in this case an OECD agreement concerning the use of export credits) can be included by reference and become the basis for international rules, even though a particular country (Brazil in this case) is not a signatory to it.[16]

Summary

In a *de jure* sense, the system of international trade rules, which for the rich countries serve as the main interface between domestic regulatory frameworks and the supra-national governance regimes, do not impinge on sovereignty. The introduction of this concept into the globalization debate is thus unwarranted, at least in connection with the system of trade rules.

In a *de facto* sense, international rules clearly have the potential to impact on domestic social choice. However, given the context in which such rules are adopted by individual countries (in the context of negotiations in which the country receives benefits in exchange for any concessions it gives), and given the scope for a country to back out of an agreement (albeit with the risk of losing concessions from other members), the implied constraints on social choice are comparatively modest, bearing in mind the caveat that these results are primarily of relevance to the rich countries only.

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[16] The *OECD Arrangement*, a "gentleman's agreement" among OECD members, establishes guidelines for terms of official export credits, including Commercial Interest Reference Rates ("CIRRs") which set minimum interest rates for long-term financing, that can be provided without challenge under the WTO agreements (i.e., that fall under the WTO's "safe harbour" provisions). *OECD Arrangement on Guidelines for Officially Supported Export Credits ("OECD Arrangement").* *Brazil - Export Financing Programme for Aircraft, Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW/2, July 26th, 2001 para 5.67, at pg 23, and paras 2.4-5, at pg 2-3.

Of Modular Economies and Social Contracts: Social Choice under Global Economic Competition

It is often argued that globalization has eroded the ability of the nation-state to preserve social policies, not necessarily because of international rules but because of international competition, especially in the realm of rule-making to attract foreign investment. Indeed, critics of globalization often argue that, through such courting of footloose capital, there is very real *de facto* cession to multinational corporations of effective control over the scope for social policy choices, especially those that embody what might be viewed as implicit "social contracts" that mitigate the harshest impacts of markets on those who join the market economy.[1]

Advocates of globalization, conversely, emphasize the gains from trade that advance consumer welfare and expand the material basis on which social programs are ultimately based, the catalytic effect of foreign direct investment, and same competitive regulatory process in promoting transparent regulatory regimes,[2] enforcement of existing laws, and establishment of minimum standards[3]—rich country rules which *ipso facto* are tinged with success, not tainted by failure.

The question then becomes the following: can the economic benefits of globalization be obtained without *unduly* inhibiting the ability of nation states to maintain or adopt culturally sensitive regulatory schemes that reflect not the tastes of an international market place but the social desires of a people?[4] And, as a key part of this question, can implicit social contracts be honoured under globalization?

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[1] See Lori Wallach and Michelle Sforza, *Whose Trade Organization? Corporate Globalization and the Erosion of Democracy*, Public Citizen, Washington DC, 1999.

[2] Ronald A. Cass, John R. Haring, "Domestic Regulation and International Trade: Where's the Race?—Lessons From Telecommunications and Export Controls", *The Political Economy of International Trade: Essays in Honor of Robert E. Hudec*, Daniel Kennedy & James Southwick eds., Cambridge University Press, New York, 2002.

[3] Michael J. Trebilcock, Trade Policy and Labour Standards, February 2002, draft, http://www.yorku.ca/robarts/

The concept of a Social Contract

Insofar as the concept of a "social contract" has some currency and validity, and insofar as each nation-state's version is rooted in a socio-economic soil that is easily disturbed by globalization[5], it provides a handy way to understand the sharp reactions to globalization, and especially those reactions based on the notion of "democratic deficits" in international governance. Indeed, the sense of betrayal implicit in the term "breach of contract" undoubtedly explains reasonably well the visceral nature of the reaction to domestic changes in response to global economic developments, little matter that no such contracts exist in explicit form to be broken in any literal sense.

At the same it subsumes a range of domestic social issues that can be readily linked to a number of international governance issues that are much and hotly debated.

In the developed countries, the idea of a social contract may be identified with the "social safety net"—typically a package of unemployment insurance, job training/retraining and/or placement assistance, and longer-term welfare for hard-to-employ individuals combined with structural assistance for regions that are disadvantaged or experiencing shocks. This is now a standard feature of the modern urbanized, industrialized economy. But that has not always been the case—nor is it even today the case in countries at very early stages of development.[6] Moreover, different societies provide differing levels of such assistance, apparently reflecting the historical evolution of their economies, their norms as regards the behaviour of corporations towards employees, their degree of social "solidarity" as evidenced by the willingness of populations to pay the taxes that finance transfer programs, the political/moral philosophies that shape their culture, the history of social activism that may have influenced their social evolution, and so forth.

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[4] Kenneth Arrow highlighted the difference in the ordering that can take place: " It is the ordering according to values which takes into account all the desires of the individual, including the highly important socializing desires, and which is primarily relevant for the achievement of a social maximum. The market mechanism, however, takes into account only the ordering according to tastes." See: Kenneth J. Arrow, *Social Choice and Individual Values*, Second Edition, 1963, Yale University Press, at 18.

[5] Globalization does not necessarily disturb by imposing requirements, but by altering the array of choices available to a society. This is a perhaps a fine distinction but an important one in view of the tenor of discussion of globalization.

Over and above the provision of various forms of social insurance, governments in industrialized economies have a broad commitment to full employment policies. This reflects the fundamental reality that the most important point of linkage that an individual (and by extension his or her dependants) has to society in the modern industrial economy is through a job that provides both, in the form of work, the means to contribute to society and, in the form of compensation, the means to make claims on the society. Politically, maintaining high employment is "job one".

While there is an obvious convenience in having a shorthand designation for the complex socio-economic features that are connoted by the term "social contract", this particular term is not without its disadvantages. The "social contract" is an emotive concept, linked as it is to the concept of "natural law" which espouses that there are natural rights that can only be compromised through a voluntary contract made by the possessors of those rights.[7] It has a long history in philosophy with a wide range of articulations. Locke's concept of the social contract involves the community entering into a contract with those in a position to govern who, as trustees, owe a fiduciary obligation to the community that is the beneficiary of this trust relationship.[8] It fits a liberal democracy, whereas the model in Hobbes' Leviathan fits more authoritarian regimes in which society is something externally imposed by the cohesive force applied by the head to its members.[9] Hume trenchantly criticized the concept of a social contract because there is no freedom of choice to join a community without the ability to leave it. Hume identifies justice, fidelity and the political duty of allegiance that flows separately from the usual moral precepts and bind government and the community in a common pact or engagement.[10]

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[6] Having the wherewithal to deliver on the protection implied by a social contract distinguishes the developed from the developing countries. There are many nations in Africa, and possibly elsewhere, where the social fabric has broken down. The ravages of AIDS/HIV in countries such as Angola, are to such an extreme that the incredible number of orphans that will soon exist, in the light of a limited life expectancy, is such that it is useless to provide support for post-secondary education because the students will likely not survive long enough. In such circumstances, the notion of a national social contract or obligation is simply untenable. The only social contract or obligation that makes sense is an international one, and this in the form of development assistance and/or debt relief.

Yet despite the troubling questions surrounding its validity it has had a persistent appeal, as evocatively brought out by Barker:

> "Here we may leave the idea of contract. Historians have not loved the idea; they know the records of history, and they do not believe that there ever was such a thing. Lawyers have not loved the idea: they know what actual contracts are, how lawyers draft them and courts enforce them, and they do not believe that the

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[7] This view is particularly evident in the theory of Locke. See: Sir Ernest Barker, *Social Contract, Locke, Hume, Rousseau*, Oxford University Press, 1960. The concept of "natural law" reached its zenith in the 17th and 18th centuries; since then, the concept has largely been discredited in the theory of jurisprudence, with a number of other views of law emerging.

[8] *Ibid., supra,* note 22 at xxiii.

[9] *Ibid.*, at xxiv-xxv

[10] *Ibid.,* at xlii-xliii If the theories of Locke or Hume are assumed, duties are owed that transcend simple contract in a manner highlighting the duty to govern according to social welfare considerations and not simply ordering on the basis of tastes through the market mechanism.

> social contract is anything more than a sham – a *quasi* or an *als ob*. And yet there must be some "soul of truth" in so old and inveterate an idea...."[11]

Moreover, the concept of an implicit social contract also usefully captures the idea of "entitlement" in politically neutral terms, a not unimportant advantage since the attack on entitlements from the "right" and the fight to preserve them from the "left" forms one of the globalization battlefronts. If we may, therefore, be allowed to proceed further with this idea, to what extent might it be said that globalization *de facto* impairs the ability of countries to maintain their implicit social contracts and with how much practical effect?

The modular nature of national economies

The great drivers of economic globalization over the past half century have been the vast expansion of trade and investment (which have had important spillover effects from traded sectors within economies to non-traded sectors), the emergence of highly integrated international financial markets, and the dominant role in international trade assumed by intra-firm trade within multinational corporations. It comes therefore as a surprise to economists that, in today's global economy, the nation state remains in economic terms highly modular.

The main empirical regularities which result in modularity are, very briefly, as follows. First, "border effects" in trade are remarkably high, even within free trade areas such as between Canada and the United States. In other words, trade flows between two regions are much larger when both lie within a common national border than when they are located in different countries, distance, economic size, per capita incomes and other factors controlled for (John McCallum's "home bias in trade" puzzle). Secondly, national savings and investments rates are far more correlated that expected given the apparent extent of capital integration of capital markets, resulting in constraints on the size of current account imbalances (the Feldstein-Horioka saving-investment puzzle). Third, investors have a far greater home bias in their portfolios than would be expected given international diversification opportunities (the French-Poterba equity home bias puzzle). And fourth, there is high degree of correlation of national income and consumption rates, indicating a lack of smoothing through international borrowing (the Backus-Kehoe-Kydland consumption correlations puzzle).[12] Finally, prices tend not to be not tightly coupled internationally—that is, the "law of one price" which holds that traded goods should have the same price in different countries, after exchange rate conversion, does not in fact tend to hold, a fact usually attributed to imperfect market information and the presence of trading costs. In other words, significant price differentials do in fact obtain across borders without triggering some form of international arbitrage (i.e., a "zone of inaction" prevails), which tends to insulate national markets somewhat.

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[11] *Ibid.*, at xliii.

This *de facto* modularity provides an important degree of flexibility for national economies to pursue independent tax and social policies, as argued persuasively by John Helliwell.[13]

Important evidential support for the proposition that policy flexibility prevails *de facto* is provided by the wide range of public sector shares of economic activity in successful countries (see, for example, OECD data on tax shares of GDP in the figure below–*dispersion big time!*). Indeed, if tax dollars are spent effectively and wisely, there is no particular constraint whatsoever on the public sector share of activity. Since governance of private sector organizations has proved to have its own problems, which suggests that no one model of socio-economic organization offers over-riding advantages, the likelihood is that mixed public-private economies will continue to predominate.

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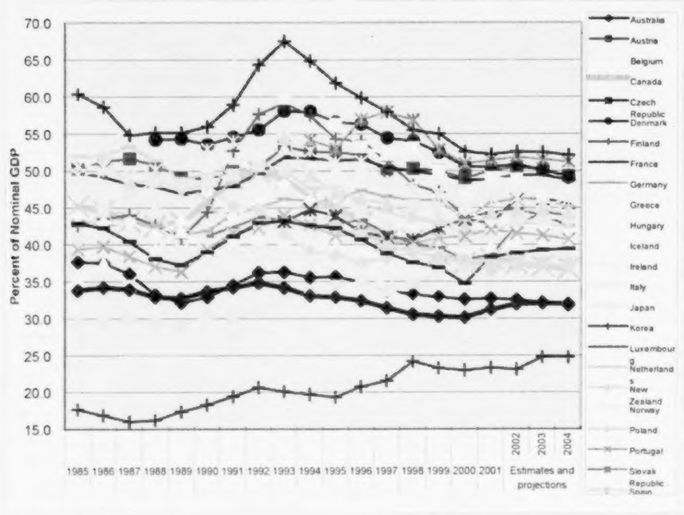
[12] These and other puzzles are summarized by Maurice Obstfeld and Kenneth Rogoff, "The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?" in Ben S. Bernanke and Kenneth Rogoff (eds.) *NBER Macroeconomics Annual 15* (Cambridge, Mass.: The MIT Press, 2000).

[13] See John F. Helliwell, *Globalization: Myths, Fact and Consequences*, Benefactors Lecture, 2000, C.D. Howe Institute, October 2000.

General Government Total Outlays as Percent of GDP



The bottom line: trends in income distribution

Governments will not of course necessarily make use of the flexibility that the evidence suggests they have. There is always the "chilling" effect of the perception of risk in being an outlier in a key policy area (e.g., tax rates). And, to flip the issue around, governments may well choose to follow the leader if what appears to be an effective approach is identified elsewhere.[14]

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[14] The rapid spread of inflation targeting is an example of this effect. The Reserve Bank of New Zealand was the first to adopt this rule in the 1980s (the 1989 Reserve Bank of New Zealand Act formalized the structure that had evolved over the preceding years). The Bank of Canada was an early adopter in 1990, with the UK and Sweden following in the next two

If there is a bottom line regarding the *de facto* impact of globalization on social choice, for many it is to be found in the actual trends in income distribution and particularly wage inequality. After all is said and done, if income is distributed with some reasonable degree of evenness (considered here on a within-country basis), other distributional issues are likely to be taken care of.

Unfortunately, while much studied, actual patterns of income distribution have proved extraordinarily reluctant to yield the secrets of what are their determinants. This reflects the wide range of complex influences on wages and other forms of income, many of which are undoubtedly more readily explained in terms of sociology or cultural anthropology than economics.

But even in terms of economic forces, income shares of various population groups are influenced by a multiplicity of factors. For example, there are important impacts in the short to medium term (meaning over the course of a decade or so) from the course of the business cycle. In the longer term (measured in terms of decades), technological change can affect particular skill groups within an economy as well as particular regions which experience internal terms of trade erosion or enhancement as a result. Shocks to socio-economic frameworks stemming from wars or macroeconomic crises (including unexpected bursts of inflation or deflation that transfer wealth between debtors and creditors) can also affect patterns of distribution. Influences can flow from changes in the political economy of a nation due, for example, to demographic trends (e.g., the bulging baby boom cohort moving through the age brackets), or political activism that influences national tax or other policies with income distributional effects. And influences can flow from socio-economic policies that affect the supply of particular skills, and thus alter the relative wages of those entering those professions.

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years; since then it has had growing acceptance. This policy practice spread not through *pressures* to harmonize, but rather through the peer networks that link central bank officials. This aspect of globalization is probably more important than many others that attract far more attention.

The complexity of the influences provides a plausible rationale why, if one were to look, it would be hard to find a clear-cut link between globalization and income distribution within a country. However, two important empirical regularities lead many analysts to *expect* to find no such link.

First, most trade takes place between countries at similar income levels, implying that the impacts would tend to be sector-specific, reflecting the influence of trade on industrial structure (e.g., due to comparative advantage), and to wash out across the whole economy.

Secondly, most capital formation within a country is financed domestically, given the international financial market aversions to sustained large current account deficits noted above. And insofar as a small portion is financed abroad, the financing usually flows between developed countries. Accordingly, given these empirical regularities, the fact that capital is relatively more mobile than labour does not necessarily imply pervasive leverage in the wage bargaining process, although specific examples would abound.

And surveys of the literature suggest that these negative expectations have largely been met: it has proved difficult to find significant effects of trade or globalization more generally on income distribution.[15] Perhaps most importantly in this regard, patterns are rarely consistent across reasonably similar countries, suggesting that such trends as emerge in one country or the other are due to domestic factors rather than more general global factors.[16]

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[15] In the Canadian context, see Philippe Massé, "Trade, Employment and Wages: A Review of the Literature" in *Trade Policy Research 2001* (Ottawa: Department of Foreign Affairs and International Trade, May 2001): 205-225.

[16] See, for example, Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998", *The Quarterly Journal of Economics* (Volume CXVIII, February 2003): 1-39. Piketty and Saez document long-term trends in US wages by level of income on the basis of tax file information. They identify major changes in the earnings of the top income earners due to events such as the 1930s Depression and WWII and associated changes in institutions and social norms (towards more

One point worth emphasizing concerns trends in the shares of corporate income going to capital versus labour. Factor shares in the US have remained impressively stable at about a 30-70 split since the 1920s. This stability has prevailed over periods when the US was a major capital exporter and when it was a major capital importer; over periods when the dollar was both weak and strong.[17] If globalization has given capital owners greater leverage, this must be being offset by other factors.

To conclude this particular discussion, one can remark on the importance of not jumping to conclusions as to what are sustainable social models. Not so long ago, Canada was widely perceived to be burdened by its social model; this was at a time of large fiscal deficits and high rates of interest on a soaring national debt. Today, that same social model, largely intact even if in need of reinvestment, coupled with a much improved fiscal situation and low interest rates, does not appear to be such a burden, at least this is not suggested by the fact that Canada has led the G-7 in growth for several years in a row. One might even conclude on the basis of the current evidence that it is Canada that has the real "Goldilocks" economy—not quite European and not American but happily in between.

But the real message is twofold: first, globalization, at least as we have known it, imposes no straitjacket on national social policies—social contracts, insofar as these have some reality, can, to all appearances, be honoured; secondly, this finding rests largely on empirical regularities that represent puzzles.

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unionization and equality of income). They also contrast the steep rise in the 1980s and 1990s of the relative earnings of the highest US income earners with similar data from France (Figure XII, pg 36); they conclude that the US phenomenon reflected domestic factors such as the changes in social norms and fiscal regimes of that era rather than global factors. In the Canadian context Massé (*supra*) notes that the increase in the supply of "knowledge" workers offset rising demand for such skills resulting in a counter-intuitive lack of change in the incomes of skilled workers in the face of apparently skill-intensive technical change—of importance here, this was contrasted with developments in the US.

[17] Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998", op. cit.; see especially figure 9, pg 20.

Supra-National Governance and the Developing Countries: Neither of Them nor for Them

Transporting social choice considerations derived from the experience of rich countries with well established democratic governance regimes to the poor is problematic, for several reasons.

First, parties to a contractual arrangement are assumed to understand the bargain that they have made and to assent to it. What happens if these elements are not present? For example, it has been argued that many participants in the multilateral trading system lack the institutional capacity to understand and to participate fully in negotiations.[1] Leaning on common law principles, it can be observed that contracts may not be enforceable where an inequality of bargaining power exists in the circumstances of an unconscionable transaction. Contracts may also be set aside, or damages awarded, in circumstances where parties have been induced to enter an agreement as a result of negligent misrepresentation. While no such remedies are available in the framework of the international agreements, these principles certainly inform judgements in the court of public opinion.

Second, it is also, on the face of it, banal to think in terms of social choice in the case of governments that cannot be said to truly represent the interests of their constituents. As the democratization and anti-corruption campaigns amply show, neither repression nor corruption is lacking within the global community.[2] Leaning on the well developed analysis of principal/agent problems, it can be seen that, in cases where the interests of the agent diverge from those of the principal, the agreements entered into by the agents will not always serve the interests of the principal and indeed might even actively serve to damage those interests. Examples abound. As the recent spate of corporate scandals shows, officers of publicly traded corporations have at times entered into agreements on behalf of the corporations that undermined the interests of the shareholders—to the point of insolvency of the corporation—to promote their own personal short-term interests. Governments are not immune to the incentives that prompt such behaviour. Indeed, agreements that strip the patrimony to the benefit of foreign investors while still yielding fabulous short-term returns to a ruling clique have been the target of criticism from civil society.

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[1] The reality behind this argument is affirmed by the importance attached to the capacity- and institution-building provisions within the Doha Declaration. The aim of these provisions is to help the developing world participate meaningfully in the negotiating rounds and WTO processes. This issue is most often raised with regard to the developing countries that signed onto the Uruguay Round single undertaking with limited if any understanding of the overall agreement—and certainly no understanding of the domestic implications. However, similar arguments can be brought to bear in the case of industrialized countries as well; the complexity of the WTO Agreement and the lack of reliable economic analysis about its consequences call into question just how "informed" were the choices by industrialized countries.

Third, a sharp distinction can be drawn between the context prevailing in a trade negotiation where governments are in a position to weigh choices and those prevailing in the context where a government is in desperate straits due to a financial crisis. For the rich countries, the interface with global governance is principally through trade rules; it has been argued that these constraints tend not to be burdensome in either *de jure* or *de facto* senses. Trade rules do not tend to bite for the poor for quite different reasons: political activism of the developing bloc secured a generalized tariff preference for developing countries in the GATT framework and eventually special and differential measures to delay and temper the impact of trade rules.[3]

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[2] See, for example, *Global Corruption Report 2003*, Transparency International, www.globalcorruptionreport.org/download.shtml. Also see UNDP publications at www.undp.org/dpa/publications/corruption/

[3] That being said, despite UNCTAD's sustained critique of the multilateral tariff structure, the trade system continues to be more restrictive of developing country exports than of the manufactures exported by the rich countries. It should be noted that developed countries worked hard to keep developing countries from defecting to UNCTAD at the expense of the GATT, and in fact, given their numbers, developing countries increasingly

Equally importantly, most poor countries do not trade much and bilateral sanctions of the sort approved by the WTO would have limited leverage. For the poor, the main interface is through the system of international finance and here the experience is very different: constraints can bind hard and penetrate domestic decision-making deeply.

It is instructive to review how the world arrived at the global governance system that confronts developing countries.

The evolution of the international governance regime interface with developing countries

The post-WWII international economic governance architecture was designed with the industrialized world in mind, and specifically with the rebuilding of that world and the re-establishment of a liberal international trading system. Its objectives were (a) to maintain a stable monetary order to facilitate trade and to prevent the "beggar-thy-neighbour" policies that had played havoc during the inter-war period, a mission given the International Monetary Fund (IMF); (b) to finance postwar reconstruction, a mission given to the International Bank for Reconstruction and Development (IBRD, better known as the World Bank); and (c) to lower the barriers to international trade, a mission intended for the International Trade Organization, but which was in fact fulfilled by the General Agreement on Trade and Tariffs (GATT).[4]

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demonstrated their clout in GATT negotiations. Indeed, they showed that they possessed the political power to push through significant reforms. Most significantly, developing countries were able to secure S&D treatment which Robert Hudec and others thought wholly counterproductive. The point is that they were able to hurt themselves in this regard (framing a rather mercantilist answer to a development problem) because they were more than just price-takers. For a discussion of the evolution of the initial preferential measures adopted by the GATT in 1965 into the familiar General System of Preferences, see Bernard M. Hoekman and Michel M. Kostecki, *The Political Economy of the World Trading System: From GATT to WTO* (Oxford: Oxford University Press, 1996), pg 236-238.

[4] The International Trade Organization (ITO) was intended to be

Cast in the Westphalian mould with "embedded liberalism"[5] as its guiding ethos, this framework was clearly *not* designed with the developing world in mind, either in terms of objectives or in terms of governance. Rather, the framework was developed by states that had internalized the framework's principles and were used to thinking of themselves as "Great Powers", operating in a multi-polar world.

The specific design reflected the thinking of the liberal internationalists (including, *inter alia*, Cordell Hull, the author of the US Trade Reciprocity Acts of 1934 and 1938 which served as the model for the GATT, and Keynes who was there at the creation) reacting to the 1930s breakdown of the global order. As Dani Rodrik put it: "The essence of the Bretton Woods-GATT regime was that countries were free to dance to their own tune as long as they removed a number of border restrictions on trade and generally did not discriminate among their trade partners".[6]

These principles and philosophies do not reflect the histories of sub-Saharan Africa where borders were arbitrarily imposed by colonial empires, nor the histories of the Middle East where

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equivalent to the IMF and the World Bank in guiding post-war reconstruction. John H. Jackson, "The Birth of the GATT-MTN System: A Constitutional Appraisal", *Law and Policy in International Business, Vol.* 12, 1980, 21 at pg 28. The ITO negotiations consisted of three negotiating sessions at London, Geneva and Havana. The result was a comprehensive treaty comprising 106 Articles and 16 Schedules known as the Havana Charter signed on March 24th, 1948 by 54 nations including Mexico. *The Havana Charter for an International Trade Organization*, U.S. Department of State, Publication 3206, Commercial Policy Series 114, released September 1948. The GATT emerged during the Geneva Round of the ITO negotiations and came into force on January 1st, 1948 with 23 nations signing the Protocol. It was intended to be temporary and designed to be annexed to the Havana Charter at the time it came into force.

[5] The term "embedded liberalism" is due to John G. Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order", International Organization, vol.36 (1982), pp. 379-415; especially see pg 393.

[6] See Dani Rodrik, "How Far will International Economic Integration Go?", *Journal of Economic Perspectives* 14 (2000), 177-186. Available at http://ksghome.harvard.edu/~.drodrik.academic.ksg/JEPrev1.PDF

the map was drawn by the victorious powers following the collapse of the Ottoman Empire in the first world war, nor Central Asia where the state structure that emerged following the collapse of the Soviet Union reflected Soviet-era population policies.

It is only one of many ironies that only the provisional GATT, which eventually provided the framework for eight rounds of multilateral negotiations, the last of which produced the World Trade Organization, really worked as intended. Yet even in this case, as the system grew to include the developing countries, it also grew in complexity by leaps and bounds. There is little doubt that many developing country signed onto the Uruguay Round deal in a manner that would *not* be considered "informed".

The World Bank, formed in 1944, did not have sufficient lending power and by 1948 was supplanted in its prime mission by the Marshall Plan. It then switched its focus to development, making traditional loans to governments at rates lower than those available through commercial banks; subsequently, through ancillary institutions, it began to increasingly make soft loans and even equity investments.[7]

Meanwhile, the IMF was formed with inadequate liquidity, hampering it in its intended liquidity support role; when the Bretton Woods system of fixed rates terminated in 1971, the IMF too had to find a new role, which was defined for it by the

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[7] The World Bank Group now comprises four institutions. The International Finance Corporation (IFC) was created in 1956 to encourage private investment in developing states by providing seed money. It provides loans and direct equity investments to private companies. In 1989, the IFC established the International Securities Group to advise how to issue stocks and have them listed. The International Development Agency (IDA) was created in 1960 to provide "soft" loans for 30 to 50 years at rates of 1 to 3 percent, while the Multilateral Investment Guarantee Agency (MIGA) was created in 1988 to insure private investment against loss from political risk. Kelly-Kate Pease, *International Organizations, Perspectives on Governance in the 21st Century*, 2nd, 181-4.

Latin Debt Crisis of the early 1980s, as a *de facto* lender of last resort to countries in crisis.[8]

As the joke goes, the Bank became a fund and the Fund became a bank.

And, as the luck of evolutionary institutional design and the law of unintended consequences would have it, two institutions with shareholder control exercised largely by the G-7 countries, became the key financiers for developing countries. To be sure, the World Bank and IMF operated in a crowded field of development institutions;[9] however, their role was especially influential by virtue of their capacity to intervene in crisis situations.

Constraints that bind

The power to intervene financially in crises also accounts for the controversy surrounding role of the international financial institutions: the worse the crisis, the more powerful their role in setting conditions for bail out packages.

As an example, consider the case of Korea during the Asian Crisis. Korea was by that time already an OECD member, having earned that membership by virtue of four decades of well-nigh spectacular growth. It had an exemplary fiscal record` and no history of monetary instability or excessive inflation. In other words, it had demonstrated more than adequate competence in managing its own affairs. The liquidity crisis which it encountered in 1997 was clearly part of a regional crisis, not specific to itself, and certainly had nothing to do with its domestic inflation record.

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[8] For a good discussion of the evolution of the IMF, see Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: Princeton University Press, 1996).

[9] Historically, the Cambrian-like explosion of development institutions dates to the mid-1960s, coincident with and/or responding to the formation of the Group of 77, a developing country bloc within the United Nations. The UN Conference on Trade and Development (UNCTAD) was launched in 1964 while the more comprehensive UN Development Program (UNDP) was created in 1965. Since then a plethora of institutions and programs have arisen to deal with development issues, including the UN Children's Fund (UNICEF), the World Food Program (WFP), the World Health Organization (WHO), as well as NGOs such as World Vision and Oxfam

Yet consider the benchmarks for compliance included in the IMF memo dated January 8th, 1998:

- Call a special session of the National Assembly shortly following the Presidential elections in December 1997 to pass the following reform bills:
    - A revised Bank of Korea Act providing for central bank independence, with price stability as its main mandate;
    - A bill to consolidate bank supervision;
    - A bill requiring that corporate financial statements be prepared on a consolidated basis and be certified by external auditors;
- Submit legislation to the first special session of the National Assembly to harmonize the Korean regime on equity purchases with OECD practices.[10]

To be sure, Korea had a financial crisis and the conditions for the loan dealt with financial engineering, not social engineering. Moreover the financial conditions reflected no more than established good practice elsewhere. That being said, both the specificity of some of the provisions and the preemption of domestic choice illustrate the sharp difference between the impact of trade rules and that of the international financial system, an impact experienced by developing countries almost routinely.

To take but one example from the above menu, consider the issue price stability. If words still mean anything, "price stability" means zero inflation as the target. This issue was explicitly debated in the Canadian context in the discussion of the choice of a monetary regime. There are many economic subtleties in defining the objective, whether it be price stability (implicitly a zero target), an inflation target of 0-2 percent or a target band of 1-3 percent as currently maintained by the Bank of Canada. Is price inflation measured properly? If quality changes are not fully reflected in measured prices then some degree of positive measured inflation is consistent with "true" price stability. In a similar vein, given that inflation rates tend to fluctuate, a zero target would imply frequent episodes of price deflation, which is a problematic condition given that interest rates cannot fall below zero, implying central bank loss of control over real interest rates (the "zero bound" problem currently facing Japan). The economic benefit of moving from a low rate to a still lower may not justify the economic costs. There are, in fact, subtle distributional implications in setting a mandate of price stability for a central bank and insisting on its independence.

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[10] "Republic of Korea – IMF Stand-By Arrangement: Summary of the Economic Program", International Monetary Fund, December 5th, 1997. Available at www.imf.org/external/np/loi/120397.HTM#memo

The above are the kinds of considerations that were weighed in Canada's choice of a 1-3 percent target. In other contexts, there are other issues.

For example, in a country in which non-traded goods prices are still adjusting to world levels, a measured positive inflation rate higher than one would normally think consistent with price stability does not impair the country's competitiveness and is indeed appropriate to its circumstances (the Balassa-Samuelson effect). In the European context, a country like Spain which is still making these adjustments can for this reason, safely run a higher inflation rate than Germany—a point which creates problems for the European Central Bank in setting nominal interest rates.

The point is not that central bank independence and price stability represent bad policies; it is just that such policies probably are best determined through a lengthy period of experimentation and analysis rather than by external fiat in the heat of a crisis.

Nor is the issue one of conditionality *per se*—or even conditionality with austerity conditions attached. Under the Bretton Woods system, the IMF provided liquidity by lending funds to nations experiencing short-term balance-of-payments problems. The amount a country could draw was linked to the size of its paid-in quota. Quotas were paid 25 percent in the reserve currency and the balance in the national currency. In turn, countries could borrow in four "tranches", the first 25 percent being automatic, the remaining 75 percent subject to IMF austerity conditions intended to promote fiscal responsibility. When applied in the context of the club that wrote these rules, there is little evidence of friction. The frictions have emerged when conditionality was applied, with the distilled experience of western industrialized countries as template, to the developing countries which did not fit that template well.

It is of course the case that a country in Korea's circumstances could refuse to accept the terms that were offered; in a strict sense, the country "chooses" the conditions in accepting the financial assistance. Accordingly, in a formal sense, there is no more impingement of sovereign choice than through trade rules. However, the position of a country in the midst of a crisis is seriously compromised in comparison to the situations that apply to countries involved in trade negotiations or trade disputes and one would not wish to stretch the point that far; there is an important and major qualitative difference.

And finally, it should be emphasized that Korea was an exceptional case: an OECD member that is also strategically important. The situation of many other developing countries is not anywhere near as advantageous. For the latter, there is a built-in margin of uncertainty as to whether and in what amounts international support will be forthcoming in the event a developing country runs into financial difficulties. This reflects straightforwardly the fact that liquidity support at times is based heavily on considerations quite independent of whether the underlying problems are of a liquidity or solvency nature—namely, whether an economy is "important" in systemic or geopolitical terms, as Korea is.[11] These judgements are made from the perspective of the principal shareholders of the IMF and World Bank and can lend themselves to damaging behaviour on the part of financial markets (e.g., "moral hazard" plays such as were prevalent in advance of Russia's default in 1998, as Russia's nuclear status led speculators to bank on a bailout). A corollary of the preceding point is that uncertainty about the provision of adequate support can obviously contribute to capital flight from countries that investors anticipate will *not* be judged to be systemically or geopolitically important.

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[11] One might note in this context the public plea made by Paul Krugman recently for financial support for the Government of Bolivia.

Conclusions

That there should be controversy about the interaction of global governance with developing countries is scarcely surprising: the wave of development failures and emerging market crises over the last several decades has spawned as many offspring in the form of critics as success has fathers. As the issue has been extensively discussed elsewhere,[12] we limit further comment here to the following observations.

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[12] For a trenchant critique (softened by its wry and sympathetic tone) of the World Bank's record, see William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (MIT Press, July 2001). A frank review but one closer to official views is provided by Stanley Fischer, *Globalization and its Challenges*, Ely Lecture, American Economic Association meetings in Washington, DC on January 3rd, 2003. A sharply critical view, focussing on the role of the IMF in the Asian Crisis is provided by Joseph E. Stiglitz, *Globalization and its Discontents*, W.W. Norton & Co., 2002. For a rebuttal to Stiglitz, see IMF Chief Economist Kenneth Rogoff's July 2002 open letter to Stiglitz available at www.imf.org/external/np/vc/2002/070202.htm. Much of the debate is centred on the set of policy prescriptions that were promoted by the World Bank and the IMF from the time of the Latin Debt Crisis. An articulation of the elements of this policy prescription by economist John Williamson, which he labelled the "Washington Consensus", has, in his words, "taken a life of its own" and served as the lightning rod for the controversies surrounding the role of the international financial institutions in the developing world. See John Williamson's comment, "The poor need a stake in developing countries", *Financial Times*, April 7th, 2003. Available at www.globalpolicy.org/socecon/develop/devthry/poverty/2003/0407washcon.htm. Interestingly, Williamson has updated the "consensus" to include policies that reduce income disparity, in addition to tweaking certain aspects of the old consensus—more flexible labour markets, improved institutions for stimulating and regulating a market economy and greater discipline over public debt. See John Williamson, *After the Washington Consensus: Restarting Growth and Reform in Latin America* (Institute for International Economics, Washington, DC).

First, there is no semblance of collective economic security built into the framework for the developing countries; this was brought home to the East Asian economies as their crisis unfolded in 1997-1998 and accounts for the attraction of the idea of an Asian Monetary Fund, similar to the European Monetary Fund at the heart of the pre-euro European Monetary System.

Second, related to the first point, it is extraordinarily important that developing countries buy into globalization on a "safety first" basis, which is consonant with the theme voiced repeatedly by Jagdish Bhagwati concerning the limited upsides and grave risks posed by capital flows.[13]

The difficulty, of course, is that buy in they apparently must, as indeed they generally have.

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[13] See Jagdish Bhagwati, *The Wind of a Hundred Days*, (Cambridge Mass., MIT Press, 2000); in particular, Part I: The Two-Edged Sword: Capital Flows.

Explaining Global Income Disparities: The Usual Suspects Are Not Talking

The dominant distributional fact in today's global economy is the vast gap that separates the income levels and living standards of the wealthiest from those of the poorest. There are large and persistent differences across continents, across countries within continents, across regions within countries, between rural and urban areas, across rural areas and across particular neighbourhoods within urban areas—and this is not to mention across ethnic and linguistic groups at each and every spatial level. As William Easterly puts it, "economic geography shows spatial concentration [of per capita incomes] worldwide. This concentration has a fractal-like quality in that it recurs at each level of aggregation."[1]

Inequality of income whether at the national or international level is, in other words, merely a particular manifestation of a pervasive feature of socio-economic structures. Presumably, it is therefore no accident that income disparity characterizes the model of globalization that we have today. Indeed, it would most likely characterize *any* model that could have conceivably have emerged out of the historical context in which it took root.

The narrower questions concerning the impact of globalization then are the following: "Has globalization exacerbated what are inevitable disparities?" If so for what reason? And, are widening differentials an unavoidable outcome? Of particular interest, it is of interest to know whether convergence (or lack of it) in income levels internationally is in any way related to the pressures (or lack thereof) on rich countries social policy preferences.

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[1] William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (MIT Press, July 2001); pg 165.

Accounting for Divergence: the Returns to Capital Story

Any traditional story about cross-country disparities in per capita incomes is almost unavoidably a story about capital—human capital as well as physical capital and the technology embodied in it. At a very basic level, the more capital an individual has at his or her disposal, the higher the expected income (conversely, of course, the more labour there is per unit of capital, the higher would be the expected return to capital). *Within a given technological setting*, increasing the amount of capital per worker tends to yield progressively lesser returns to the investor—thus, we tend to see eventually diminishing returns to capital.

Making allowance for specialized skills and specialized machines that are combined in the act of production, it can be seen that the returns to one form of capital depend on the presence of other types of capital. This explains why returns to highly skilled persons are much higher in rich countries, where their skills are in abundant supply but where they can be combined with other forms of human and physical capital. In poor countries, the returns to both labour and capital tend to be low because of missing forms of human and physical capital that are needed to complement those which are available.

To appreciate the significance of complementary forms of capital, consider the complexity of the process of production and marketing of anything even a relatively uncomplicated product. If any part of the production-marketing chain is lacking—for example the business acumen in arranging export financing or in negotiating the quotas that apply to international trade that product—the capital invested in the other parts of the chain yields much reduced returns to the investor.[2] By contrast, the returns to any such investment where there is an abundance of the other required elements of the overall production-marketing chain yield higher returns.

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[2] This follows the description of the launching of the Bangladeshi garment industry in William Easterly, op. cit., pg 146-148.

Accordingly, in cross-country comparisons, rather than observing an overall *inverse* relationship between the abundance of physical or human capital and the returns to it (diminishing returns), we tend to observe a *positive* relationship (increasing returns).

The very same logic explains why industrial production is tightly concentrated in large urban centres where a greater range of complementary human and physical capital can be found. In modern jargon, we speak of "agglomeration" and "clustering".[3]

Evidence for both decreasing returns and increasing returns can be found in various contexts; the complex patterns as regards returns to capital witnessed in the world reflect the interplay of these forces.

Increasing returns implies divergence of incomes. The more specialized and refined skills and the most advanced forms of capital that embody the cutting edge of technology will tend to be both comparatively scarce (being new and/or expensive to acquire) and to require association with a wide range of complementary skills and capital to earn maximum returns. Regional concentration of such skills and capital follows logically and since these skills and capital command higher returns, regional concentration of income is implied.

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[3] There is an important analogy in this story to innovation. New ideas usually arise by connecting existing ideas; as an obvious example, the combination of the internal combustion engine and the horse-drawn carriage yielded the automobile. The richer the existing range of ideas (or alternatively of technologies or products) the greater the scope for new ideas to be found. And here the math is interesting: insofar as new ideas are created by combination or recombination of existing ideas, for each new idea conceived, a whole new range of possibilities arises from the possible combination of it with those already existing. The potential field of new ideas expands combinatorially; combinatorial expansion dominates exponential growth the way that exponential growth dominates linear growth. Thus, even if most potential combinations are sterile, the math implies a powerful acceleration of technological growth, and that certainly accords with the observed historical acceleration of technological innovation. By the same token, innovation will tend to be disproportionately concentrated in areas that are rich in existing ideas—i.e., where there are concentrated populations of highly knowledgeable individuals.

Explaining Catch-up: the Trade and Technology Story

The increasing returns story is most compelling when told about what is happening at or near the technological frontier. To explain a pervasive long-term divergence of incomes, it needs to be coupled with a story explaining a comparatively slow pace of diffusion of technology and business know-how through and between economies.

For example, the presumption long has been that developing countries *should* be able to grow faster than the developed, with the observed result being convergence of earnings in low-income countries towards levels in the higher-income countries. The logic behind this expectation is simple. In a technological sense, the advanced countries have pushed out what economists have termed the "production possibilities frontier" and must work hard to grow further by exploiting untapped efficiency gains and through further fundamental innovation. Developing countries operating well inside this frontier should be able to grow much more quickly by adopting already well established production technologies and "best practices" in terms of economic policy and socio-economic organization.[4]

Even if such "catch-up growth" does not take an economy all the way to the true cutting edge of a Silicon Valley, there is no apparent reason why it should not permit a country to move rapidly at least to the income levels in rich country regions that are characterized by mature industries exploiting standard, well-established technologies. And insofar as there has been "catch-up growth" such as was witnessed in the East Asian "miracle", it was and continues to be associated with rapid assimilation of existing technology, supported by high savings and investment rates—rates that are substantially higher than in the developed world, more or less as would be expected based on conventional economic theory.[5]

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[4] It is interesting to observe in passing that the convergence is not to some average level of technological capacity but to the frontier. See Robert J. Barro and Xavier Sala-i-Martin "Technological Diffusion, Convergence, and Growth", *NBER Working Paper 5151*, June 1995. Since real incomes are determined by real production possibilities, the advance of real incomes in the developing countries does not (ignoring for the moment transitional adjustment costs) undermine real incomes in those countries already at the technological frontier. Industrializing China thus does not become the "workshop of the world"—indeed, China will in the long run import about as much as it exports as there are limits to the utility of any mercantilist build up of foreign exchange.

Trade and investment *should* work powerfully to drive such convergence. Very briefly, if factors of production (labour and capital) are mobile, workers and owners of capital shift to markets where their services are relatively scarce and hence their potential earnings are highest. The interaction between supply of and demand for the factors of production directly tends to equalize incomes—or at least to narrow inequality to a minimum level where costs of factor movement outweigh marginal benefits from such relocation. Even if factors of production are not mobile, trade in goods and services delivers the same result as is intuitively obvious when one considers that the goods and services embody the factor services—in other words, trade in goods and services is just an indirect way to trade the factor services. In short, a significant expansion of trade in goods and services should exert a powerful albeit indirect convergence pressures on incomes.

Implicit in the above story is an ability of countries or regions that do not produce new technology to acquire it, either directly by licensing, indirectly by attracting foreign direct investment (or intra-national investment) that employs technology, or most generally by trading for the capital equipment and/or end products that embody the technology. That after all is essentially the story of Canada, which for the greater part of its history has grown by importing technology rather than developing it.[6]

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[5] During the catch-up phase in East Asia, "Tigers" such as Korea and Taiwan were not prominent innovators in the sense of developing new technology, but they were able to absorb technology developed elsewhere and put it to good use through heavy investment to become industrial powers in a handful of decades. This in fact served as the basis for Paul Krugman's often-cited and much-disputed critique of the Asian "miracle" as being due to no more than mobilization of latent capital and labour resources, a process that would peter out when convergence had been fully achieved. See Paul Krugman, "Myth of Asia's Miracle", *Foreign Affairs*, November 1994.

The actual expansion of trade in the modern era of globalization has been quite phenomenal. The WTO's 2002 *International Trade Statistics* show that, in the period 1950 to 2000, world merchandise trade volume grew at an average annual rate of 6.2 percent, while during the same 50 years the pace of growth in world output was 3.9 percent.[7] The result is that world merchandise trade increased by about 20 times while world output increased by only 6.4 times. For the world, the ratio of exports of goods and services to GDP rose from 7.9 percent in 1950 to 19.2 percent in 2000.[8] For developing countries, the export share of GDP rose to 21.8 percent in 2000.[9] And these figures are more than doubled when the sales of multinational firms through their foreign establishments are factored into the equation—sales through foreign establishments being an alternative to cross-border trade and, in the case of many services, the only practical way to conduct trade.

By conventional economic theory, therefore, we should have witnessed a significant degree of income convergence globally during this period. And, indeed, insofar as there have been some cases of convergence, these have been nations that became successful traders; again, the prime example is furnished by the East Asian "miracle" economies.[10]

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[6] This story holds even if a country that is not introducing new innovations experiences an outflow of highly skilled professionals to countries that are actively innovating—the sort of "brain drain" issue that has actively been discussed in Canada.

[7] Acquired from the World Trade Organization website www.wto.org/english/res_e/statis_e/statis_e.htm on March 4th, 2003.

[8] "Some Facts and Figures, Data for Doha" www.wto.org/english/thewto_e/minist_e/brief_e/brief21_e.htm

[9] "Adjusting to a Globalized Economy" Eduardo Aninat, Deputy Managing Director, IMF, Second Annual America's Forum, October 13th, 2000, www.imf.org/external/np/speeches/2000/101300.htm

[10] In this connection, it must be pointed out that while some countries have managed to integrate into the global trading system and to experience

And, it is also important to observe that some cases of convergence across regions within individual states have been documented. For example, studies of per capita incomes trends across the US states and Japanese prefectures, where internal barriers to technology diffusion and trade and investment are low, appear to confirm convergence, albeit at a surprisingly slow pace (about two percent per year).[11] A similar result is in evidence within Europe.

The puzzles persist

Convergence and divergence co-exist. At some times and in some places, we observe convergence. Yet, as has been pointed out, income differentials across rural agrarian societies are comparatively small; since the rich industrialized countries were themselves agrarian not so long ago, it is evident that over the several hundred years of industrialization the *dominant* trend was and still is towards divergence, not convergence.[12]

There is no shortage of explanations as to why divergence rather than convergence is the dominant force.

One answer is that it is just plain hard to develop. After all, if the Ozarks haven't managed to plug into the US economy, why should we expect states in far less ideal circumstances such as those in central Sub-Saharan Africa to plug into the global economy?[13]

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income convergence, others have traded heavily but not experienced convergence and, of course, still others have not managed to get a foothold in the trading system at all despite trying.

[11] See Xavier X. Sala-i-Martin, "The Classical Approach to 'Convergence Analysis", *The Economic Journal*, 106 (July 1996), 1019-1936.

[12] William Easterly, "The Elusive Quest for Growth", op. cit., pg 62.

[13] The difficulties of development at the international level have only mirrored the frustration of regional development at the national level where the same mixed pattern of some success and much failure has also emerged. Increasing returns has been adduced to explain why many backward nations

Tastes can also explain some measure of divergence: Europeans, for example, have lower rates of labour force participation and work shorter hours than Americans.[14] This largely explains the gap between their per capita GDP. To each his own, as it were.

Generalized, the latter argument comes out as the theory of "conditional convergence": that is, a complex set of national characteristics determines different levels of potential incomes towards which these nations "converge", even as they diverge across the broad spectrum of the rich and poor.[15] While conditional convergence nicely explains some degree of divergence, one would not want to use it to explain the extent of divergence seen today. That would imply that countries are locked into low-per-capita-income states by certain characteristics. This notion flies as much in the face of the available evidence that some states break out as to ignore the fact that low-income states are generally failing to do so. After all, it is unlikely that anyone would have singled out Korea in 1960 to shed its characteristics of a backward agrarian state to become a phenomenal industrial success story over the next 40 years. Interestingly in this connection, Stanley Fischer has recently summarized the current understanding as follows: "The weight of the evidence appears now to have moved away from the initial conclusion of conditional convergence towards a view that there is a convergence club among the high income

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have failed to "take off" as was optimistically expected with the help of international financial program support. Easterly argues that increasing returns "lock in" countries into poverty traps because the absence of some types of skills and or capital create a disincentive to invest in others. There is a co-ordination failure and all economic agents fail to invest in education or physical capital. See Easterly, op. cit., pg 168.

[14] The converse argument is, of course, that the differences in preferences are simply the endogenous response to price signals.

[15] For a recent exposition of the convergence literature which sets out the evidence on conditional convergence, see Xavier X. Sala-i-Martin, "The Classical Approach to 'Convergence Analysis", *The Economic Journal*, 106 (July 1996), 1019-1936.

OECD countries, while lower income countries are converging to a lower income level".[16] The latter theory of polarization and stratification is referred to as the "twin peaks" theory.[17]

As development became a growth industry in the post-WWII period, various programs have been tried to re-engineer the characteristics of countries to put them on the path to prosperity. Berkeley economist Bradford DeLong characterized the reform waves as follows: "Since World War II there have been at least six such crusades [for development]: the "building socialism" crusade, the "financing gap" crusade, the "import substitution" crusade, the "aid for education" crusade, the "oil money recycling" crusade, and the "population boom" crusade. All of them failed to spark rapid economic development."[18] DeLong groups the current initiatives for development into the seventh or "neo-classical crusade" and proceeds to add that he, as a self-described subscriber to neo-classicism, expects it to fail as well.

One thing is clear, however: the story of convergence is not principally or even importantly about large volumes of capital flowing from rich countries to the poor. Where foreign direct investment brings a missing bit of the puzzle, its catalytic effect can be huge.[19] But this is a far more subtle story than factories in rich countries being shipped to poor countries and driving wages to equality. The latter effect is not entirely absent from the picture, but it is clearly not central to the story of convergence or lack thereof.

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[16] See Stanley Fischer, *Globalization and its Challenges*, Ely Lecture presented at the American Economic Association meetings in Washington, DC, January 3rd, 2003; pg 12.

[17] See Danny T. Quah, "Twin Peaks: Growth and Convergence in Models of distribution Dynamics", *The Economic Journal*, Volume 106, Issue 437 (July 1996): 1045-1055.

[18] See J. Bradford DeLong, "The Last Development Crusade", a review of William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, op. cit., acquired at http://econ161.berkeley.edu/TotW/Easterly_neoliberal.html.

[19] William Easterly provides a compelling example in the story of the beginnings of the Bangladeshi garment industry, which was triggered by a Japanese investment. See William Easterly, op. cit., pg 147-150.

Nor, properly considered, can it be concluded that development is primarily about the characteristics of individual nations ("initial conditions"), notwithstanding the intellectual capital that has been invested in this opinion. Socio-economic engineering aimed at establishing the right conditions has not had success, implicitly calling into question what can be learned from this approach. And the longer the set of necessary conditions grows, the less likely it becomes that any country could ever develop pursuant to the implied policy prescription.

And that returns us to the original puzzle: why has the explosion of trade and investment as well as direct technology transfer (not to mention policy emphasis by national governments and international financial institutions on education and savings and investment) failed to ignite catch up growth more widely? Why is it possible to do a taxonomy of nations, as Jeffrey Sachs has done, that sorts countries into: (a) a "technological first world of innovators"; (b) a second world of "technological adopters" which tend to be clustered around the technological innovators, receive FDI and export technology-intensive goods; and (c) the rest of the world, which is described as "technologically stagnant"? [20]

For the record, Sachs argues that the technologically stagnant tend to be geographically more distant from the technological innovators and afflicted with collapsing social structures due to disease (especially AIDS) and/or reliance on primary commodities, which are continuously being "innovated against" and hence face a long-term decline in terms of trade that makes them a very weak basis for development.

Yet, given the steep decline in transportation and communications costs—which obviously was not limited to certain regions and which has sometimes even be called the

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[20] See Jeffrey D. Sachs, "A New Framework for Globalization," paper delivered at the conference *Efficiency, Equity and Legitimacy: The Multilateral Trading System at the Millennium*, Harvard University (June 1-2, 2000).

"death of distance"—the conditions were in some ways unusually propitious for a wider group of countries to join the convergence club. The apparent continued importance of geographical location in determining which countries joined this club is therefore at least *prima facie* puzzling—especially given the seemingly strong confirmation by East Asia of the expectations of the main workhorse economic theories. After all, East Asia is far more geographically remote from the prime centres of innovation than North Africa or Latin America. While Japan has since become an important innovator, it started its technological ascent as an adopter of technology that was produced primarily in the US on the opposite side of the planet.

For those who are inclined to be sceptical, there are more questions than answers as regards the source of the income disparities to be seen between the rich and poor countries in our globalized economy.

On the Episodic Nature of Entry into and Exit from the "Convergence Club"

Research on economic development has largely focused on the characteristics of individual countries that might systematically determine success. While many correlations have been extracted from the data, cause and effect are difficult to disentangle; a reliable blueprint for development has eluded researchers. The Washington Consensus, perhaps now in updated form, still commands the position of conventional wisdom but its formulation is now so demanding as to cause more than one observer to wonder whether it in effect requires a country to be developed as a pre-condition for development.

Intriguingly, the record of convergence and divergence is highly inconsistent over time. Some historical periods appear to feature more entrants into the convergence club than other historical periods—and the most recent era has witnessed significant numbers of departures from this club.

The episodic nature of convergence suggests that different contexts are more or less conducive for development. This is an important issue: if we cannot, as it were, "bottle the ingredients" that make development work, but could identify contextual factors that make development more likely—and which might be amenable to policy manipulation—that would be a step in the right direction.

To get at this issue, we review the convergence record over time, relate the historical pattern to global exchange rate regime changes and associated changes in price behaviour.

Convergence during Alternative Globalization Eras

The first major era of globalization stretched from the Napoleonic wars to the outbreak of WW1. Consider the following description of globalization during this period:

> "In the decades after the Napoleonic Wars, trade barriers fell dramatically, and capital and labour became exceptionally mobile. A dismantling of the byzantine tariffs, prohibitions, and regulations of the eighteenth century mercantilist empires began the process. From mid-century, the technology of iron and steam conquered distance, dramatically reducing the natural protection that transportation cost had hitherto provided. In the last quarter of the century, political reaction to imports and immigration slowed international convergence somewhat but did not eliminate it. To observers today, the globalization of factor markets seems even more striking than that of trade. Labour migrated largely free from government regulation and technological improvement made international travel swift and safe. Foreign investment faced few regulatory impediments while the new telegraph and improved stock markets made information more easily available and the international gold standard provided an international monetary standard whose stability investors today can only envy."[1]

With a few minor changes, this would serve as an account of the era of globalization that followed World War II, when the trade barriers erected during the 1930s were dismantled, when the ongoing technological revolution in transportation and telecommunications further reduced the natural barriers of distance, and when global trade and investment boomed.

There are several striking features in this comparison.

First, the key elements of globalization are evident in both eras; indeed, 19th Century globalization apparently faced fewer barriers—labour and capital mobility was greater than today.

Second, in contrast to the recent era, during the earlier era of globalization skilled labour and capital flowed from the core—

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[1] C. Nick Harley, "A Review of "O'Rourke and Williamson's Globalization and History: The Evolution of a Nineteenth Century Atlantic Economy", *Journal of Economic Literature*, Vol. XXXVII (December 2000): 926-935; at pg 926-927.

the industrialized heart of Europe and from the London capital market—to the periphery.

Third, the comparative stability of the monetary standard in the earlier era (actually during the period of the international gold standard which emerged following 1870) stands out.

The first era of globalization can be broken down into two periods: 1820-1870 and 1870-1914. The extent of convergence was very limited in the earlier period.[2]

	Joined Convergence Club	Possible Members	Fallen Out
1820 to 1870	Britain, North-Eastern U.S., Belgium		

Economic progress was also being realized elsewhere in this period. As Dowrick and DeLong note "Industrialization had begun to spread elsewhere, to Canada, to the rest of the United States, of the Netherlands, to Germany, to Switzerland, to what is now Austria and the Czech Republic, and to France." However, as they go on to observe, "all of these economies found themselves further from Britain in industrial structure in 1870 than they had been back in 1820."

This record can be contrasted with the ensuing period when the convergence club expanded dramatically. Dowrick and DeLong attribute this wave of entrants to the first "era of globalization, [and] the coming of the steamship and the telegraph … [which] made the technology transfer to enable this 'rich peripheral' industrialization feasible."[3]

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[2] Members of the "Convergence Club" are taken from Steve Dowrick and J. Bradford DeLong, "Globalisation and Convergence", paper given at the *Globalisation and International Trade Workshop*, University of Sydney, May 1-2, 2002, www.econ.usyd.edu.au/global/trade.htm. They defined entrants as economies which experienced per capita GDP convergence relative to the North Atlantic level, and also a similar extent of industrial development and structural change as well. This means that not only did economies have to catch up to a moving target (the expanding economic power of Britain or the United States), but must also had to improve their level of industrialization vis-a-vis Britain or the U.S. to be considered a member.

[3] Steve Dowrick and J. Bradford DeLong, "Globalisation and Convergence". Presented at the *Globalisation and International Trade*

	Joined Convergence Club	Possible Members	Fallen Out
1870 to 1914	Netherlands, France, Germany, Switzerland, Spain, Italy, Austria, Hungary, Czech Republic, Denmark, Norway, Sweden, Finland, Ireland Canada, Western U.S., Japan, Australia, New Zealand, Argentina, Chile, Uruguay, Argentina	South Africa	

The period between the world wars was also surprisingly a period of convergence.[4] Although the destruction wrought by war and the Great Depression make it difficult to discern trends in this period,[5] the convergence club is thought to have grown despite the fact that barriers to trade and investment going up instead of down, due to the continued flow of information and technology.[6]

	Joined Convergence Club	Possible Members	Fallen Out
1914 to 1950	Soviet Union, Southern U.S., Korea, Taiwan, Venezuela, Peru, Brazil Morocco, Algeria, Tunisia, South Africa	Ghana, Ivory Coast, Kenya, Togo, Benin, Tanzania, Nigeria	

The period following WWII witnessed a significant recovery of incomes in war-ravaged countries, especially Western Europe but also more broadly. As a result, there was considerable compression of income differentials that had been widened by the devastation of war. Developing countries enjoyed a period of solid growth in per capita incomes and even the Soviet

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Workshop, University of Sydney, May 2002, pg 14. Available at http://ecocomm.anu.edu.au/economics/staff/dowrick/GlobCon-conference-paper.PDF

[4] Branko Milanovic, "Unexpected Convergence", Working Paper, September 2002, available at: www.networkideas.org/feathm/sep2002/Unexpected_Convergence.pdf

[5] Dowrick and DeLong, *op. cit.*, pg 17.

[6] Branko Milanovic, op cit., pg 21-22.

Union and its economic satellites experienced improving living standards during postwar reconstruction.

However, in subsequent decades, the overall picture turned into one of general disappointment, apart from of course East Asia's export-led economic miracle that extended into the 1990s. Since the initial postwar bounce, Latin America, South Asia, Africa and the Middle East have had their ups and downs and on balance failed to keep up with the best performing economies, while members of the Soviet bloc lapsed into stagnation and an eventual relapse into more or less developing country status as "transition economies". Accordingly, membership in the convergence club was in flux:

	Joined Convergence Club	Possible Members	Fallen Out
1950 to 2000	China, Hong Kong, Thailand, Singapore, Malaysia [post 1965], Indonesia [post 1978], India [post 1980] Yugoslavia, Romania, Bulgaria Greece, Turkey, Israel, Egypt, Botswana Mexico, Columbia, Nicaragua, Honduras		Venezuela, Peru, Argentina, Chile, Uruguay Ghana, Ivory Coast, Kenya, Togo, Benin, Tanzania, Nigeria, Morocco, Algeria, Tunisia, South Africa Former Soviet Union (Russia, Ukraine, Belarus, Latvia, Estonia, Lithuania)

While Dowrick and DeLong do not split the period, it is evident that the entire postwar era was not one of persistent trends. Importantly, growth of per capita incomes in the developing countries tailed off badly after the 1970s (see figure below). Moses Abramovitz quite explicitly dates the breakpoint, noting "the retardation in productivity growth suffered by the same group of followers since 1973".[7] The departures from the convergence club are thus clustered in the latter part of the period when per capita GDP growth in the developing countries plunged (see Figure 1). At the same time, it cannot be ignored that East Asia in particular continued to add entrants in the latter part of the period as its "miracle" unfolded.

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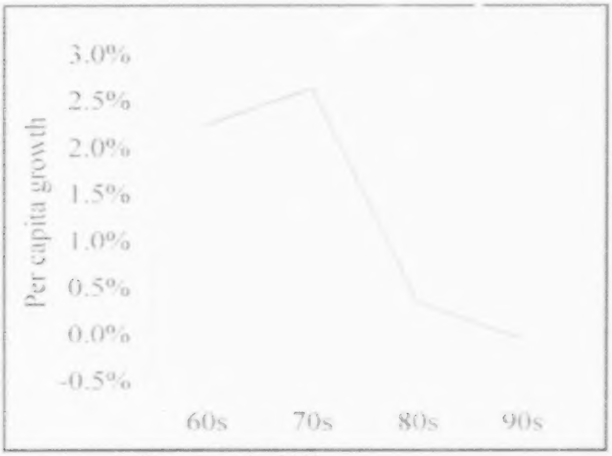
[7] Moses Abramovitz, "Catching Up, Forging Ahead, and Falling Behind", *The Journal of Economic History*, 46(2) June 1986: 385-406; at pg 385.

Figure 1. Per Capita GDP Growth, Developing Countries, 1960s – 1990s



Source: William Easterly, 2003

The pattern in the data

The interesting pattern that emerges from these data is the asymmetry between the two periods. In the 19th Century globalization wave, there was a steep gain in entrants in the second half of the period, sometimes attributed to technological progress. In the 20th Century wave, there was a steep loss of members in the second half of period, despite the fact that technological progress steepened if anything. This is anomalous and that makes it interesting. Anomalies should be respected: for they often point to important knowledge.

Since there are as many stories as there are countries, any systemic influence that could account for the asymmetry must be presumed to be one of many factors. Its role would presumably be to raise or lower the odds of any given country joining (leaving) the convergence club. Yet, with these caveats in mind, we observe that the early 1870s marked the beginning of the international gold standard while the 1970s witnessed the breakdown of the Bretton Woods gold-backed dollar standard.

Pre-1870, the monetary standards around the world varied with some countries on gold, others on silver and still others with bimetallic (gold and silver). In some countries, copper was part of the mix. The trigger for the formation of the international gold is usually identified as Germany's switch to the gold standard following its victory in the Franco-Prussian war, using the indemnification received from France to acquire the necessary gold reserves, while at the same time dumping its silver. Germany's switch to gold meant that Europe's two leading industrial powers were on the gold standard. This triggered a global shift towards gold-backed currency and thus ushered in the international gold standard.[8] While the snowball effect took time, and even at the outbreak of the First World War its reach was not global, economic historians comment on the remarkable degree of price stability evident in this era.[9]

With this history in mind, it is interesting to note that studies of the period up to 1870 find strong divergence. For the period after 1870, studies vary in their conclusion as to when convergence started: some place it at about 1880 (based on the most commonly cited data, namely that compiled by Angus Maddison) and one study at about 1890.[10] The latter date also turns out to be of some significance in that it marks the end of the great deflation that was associated with the demonetization of silver as the world switched to gold.[11]

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[8] For a history of this period, see Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: Princeton University Press, 1996).

[9] See Harley footnote 66 supra.

[10] See Branko Milanovic's discussion at pg 16-20.

[11] See Barry Eichengreen, *op. cit.*, pg 19.

The Bretton Woods system breakdown started with the August 15th, 1971 flotation of the US dollar following implementation of the Nixon Measures. However, a new fixed exchange rate regime with modestly revised parities was cobbled together at a meeting at the Smithsonian Institute in December 1971. These arrangements quickly unravelled and collapsed over the course of the Spring of 1973 as country after country floated its currency.[12] The current international exchange rate regime—effectively the international dollar standard—has since evolved as a mixed regime in which the major currencies floated against each other while second-tier currencies adopted varying forms of floating, managed floating or soft or hard pegs to one of the major currencies.

The clear inference is that convergence was stronger under the more rigid regime in both 19th Century and 20th Century globalization. Even as a conjecture, this may be taken as sheer heresy since it is widely held that fixed exchange rates are the *cause* of crises, not the reason for rapid growth. However, it is important to bear in mind that what is at issue here is a *regime*, not the case for an individual economy floating or not floating, against the background of the modern mixed regime (which is the fact base on which the modern case for floating exchange rates is built). It is interesting to see where this thought leads.

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[12] The breakdown of Bretton Woods arrangements is usually described as an inevitable consequence of the "impossible trinity" of independent monetary policy, a fixed exchange rate and capital mobility. The rise in capital flows over the postwar period is described as making the management of the fixed exchange rate regime impossible, necessitating the move to floating exchange rates. Vietnam War-era "guns and butter" policies in the US which weakened its external balances and undermined the stability of the US dollar determined the timing of the break down. The earlier break down of the pre-WWI gold standard can be traced to the determined prosecution of WWI to its bitter end, rather than an early truce; the result was a huge wartime inflation and erosion of Britain's external balances. The attempt to restore the gold standard following WWI is generally judged in retrospect to have been badly managed. For a good history, see Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton: Princeton University Press, 1996).

The behaviour of prices

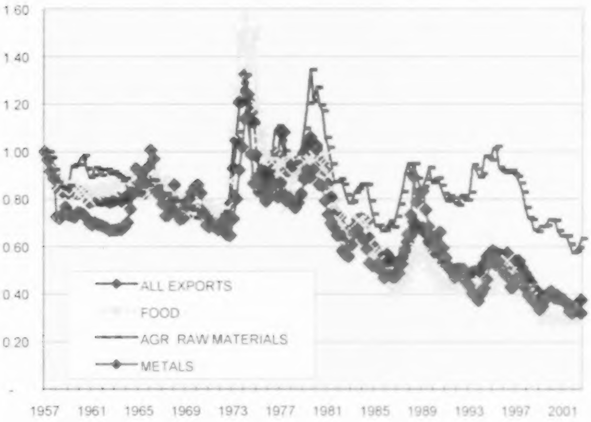
Economic theory is in large measure a story about prices. Price signals tell producers what is in demand and what is not. Prices in capital markets serve to regulate savings and investment and prices in labour markets guide workers to invest in skills that are most in demand. In modern macroeconomic practice, concern about the role of high and variable inflation in distorting price signals and undermining economic efficiency formed the bedrock of the disinflationary monetary policies of the 1980s and 1990s. The stagnation and ultimate collapse of centrally planned economies is generally understood to have been significantly abetted by suppression of price signals.

In short, if one is looking for a truly powerful and pervasive factor to explain large scale dysfunction in the international economy, with sufficient power to undermine the effects of the massive expansion of trade that was experienced in the post-WWII period, one would start by examining the information content of international prices.

The breakdown of the Bretton Woods arrangements is associated with an immediate and surprisingly large surge in the prices of internationally traded commodities (see Figure 2). While the actual devaluation of the US dollar following the breakdown of the fixed exchange rate regime was not all that large, in the transition to a floating exchange rate regime, commodity prices appear to have literally come unhinged—and the first move was sharply up (which notably was against the long-term trend in real terms).

There are straightforward linkages that can be made between the observed explosion of price volatility in the post-Bretton Woods era to the development failures observed in the decades that followed the exchange rate regime change. In country after country, development failure is associated with stories of failed investments financed by borrowing that could not be repaid, and a flowering (if one can use that word) of conflict and corruption. Such developments can flow naturally from a sudden leap in prices of a commodity. Responding to price signals, people invest; if they lack the funds, they borrow to take advantage of the newfound opportunities—and usually find willing lenders, no less impressed by the possible returns. Meanwhile, outsiders scramble to get their share of the new cornucopia of rent, by hook, by crook or sometimes even by force. A subsequent price collapse—the logical consequence where the initial increase did not reflect fundamental value—leaves mountains of unpayable debt, accounting irregularities as those responsible try to cover their mistakes, and ultimately ignominious and often disastrous failure.

Figure 2. Selected Commodity Price Indexes, Constant US dollars, 1957-2002:Q1 - 1957 = 1.00



Source: International Monetary Fund, International Financial Statistics, December 2002.

By the story above, the windfall of spiking commodity prices was the downfall of development. Consider, for example, William Easterly's description of Mexico's recent history:

> "Mexico enjoyed macroeconomic stability from 1950 to 1972, an era that earned the moniker 'stabilizing development'. The exchange rate of pesos for dollars staged fixed for all those years. Inflation was low. The coun-

try had robust per capita growth of 3.2 percent per year".[13]

Then Mexico slid into a series of debt crises, driven by external borrowing based on the rents conferred by spiking oil prices. The more oil Mexico found (e.g., the Campeche oil discoveries of the late 1970s-early 1980s) the greater the eventual magnitude of its problems became. Curiously, Easterly draws no linkage between the fixed exchange that prevailed from 1950 to 1972 and the strong growth of that era; nor does he link the end-year of that period to the changes going on at that time in the international exchange rate regime. Rather he comments on the Mexican government elected in 1970.

But lest one assume that the problems that followed the outbreak of price volatility were due to weak institutions of the developing countries, it needs to be pointed out that very similar stories unfolded in some developed countries.

For example, in the United States, the Texas oil patch also benefited from the leap in oil rents in 1973. The resulting real estate boom turned into a bust when the rise in the US dollar during the Volcker Fed's disinflation drive caused oil prices to tank in the early 1980s. It is not at all accidental that the US Savings and Loan crisis found its epicentre in Texas. And, notably, the emphasis on moral hazard in the financial literature was greatly increased by the research into the S&L crisis.

A variant of this story emerged in Canada. Partly due to sounder financial sector regulation,[14] Canada avoided an S&L-type crisis, even though the ingredients were present (an oil patch in Alberta, a hot real estate market followed by a sharp downturn). However, the soaring oil rents in Alberta led to the National Energy Policy of 1980, which sought to redistribute those rents. In Canada, the fallout in terms of domestic friction was contained. But in other countries similar struggles over rents spiralled out of control; indeed, rent grabs have been identified as one root cause of "failed states".[15]

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[13] See William Easterly, "The Elusive Quest for Growth", *op. cit.*, pg 223.

[14] Canada deregulated both lending and deposit interest rates with the 1967 Bank Act reform; the US maintained interest rate controls in the form of Regulation Q ceilings until 1980, by which time the inflation of the 1970s had undermined the balance sheets of the S&Ls. As well, Canada's banking system was regionally diversified while the US still maintained restrictions on inter-state banking. As a result, Canada witnessed only three small bank failures in the 1980s (Northland Bank, Canadian Commercial Bank and Bank of British Columbia, all regional banks exposed to the oil patch), in sharp contrast to the much greater fall-out in the US S&L crisis.

Thus corruption, internecine friction (even warfare), failed states, can all be seen as endogenous to price movements. Parenthetically, one might note that it is sometimes exuberantly claimed that "Greed works!" It does nothing of the sort. Greed is the author of the "tragedy of the commons"; it is the source of the "curse of oil". Its ethos is acquisitive and appropriative; it seeks out the windfall. It has nothing to do with the vision and industry, conditioned by discipline and passion, which are required for creation. Under stable price regimes, rewards go to the creative; when prices fluctuate widely, they go to the lucky.

Its not simply "volatility"

It is old news that price behaviour became more volatile in the post-Bretton Woods era. But there is volatility and then there is volatility. The issue is not that the amplitude of fluctuations increased—that would be a simple version of increased volatility, presumably something that markets could deal with quite easily once the pattern established itself. The problem appears to be difficulty of identifying equilibrium.

Although "equilibrium prices" may never be attained in actual markets, they can be thought of as representing a point of attraction towards which actual prices will tend to gravitate, or put another way around which they might fluctuate.

An interesting way illustrate price behaviour is a connected scatter plot, in which the price in one year is plotted against the price in the preceding year.[16] Presented this way, a perfectly stable price is represented by a point. A price cycling around a central value or attractor point will trace out an ellipse; the larger the fluctuations, the larger the orbit. A price that is simply growing will trace out a line moving away from the origin.

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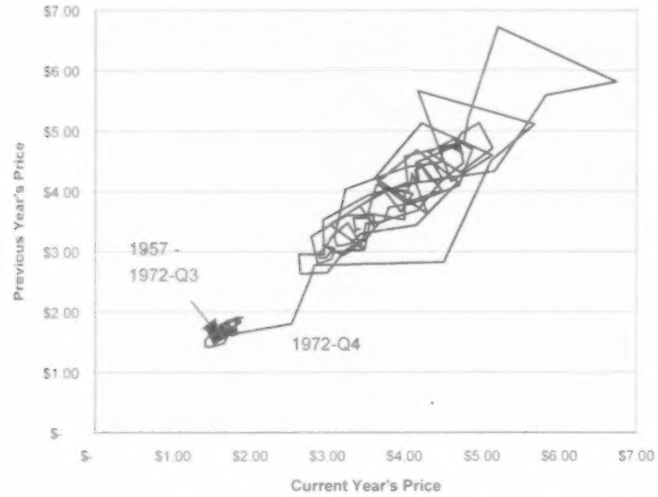
[15] See William Easterly, "The Elusive Quest for Growth", *op. cit.*, pg 134-135 for the story of the struggle in Côte d'Ivoire over the windfall rents conferred by soaring coffee and cocoa prices in the 1970s.

Figure 3 shows a connected scatter plot for the price of wheat, in nominal terms, from 1957 to the present. As can be seen, wheat prices moved in the vicinity of an attractor in the US$1.70/bushel until the 4th quarter of 1972 when they broke out; then ensued what perhaps is best described by the data.

Figure 3. Connected Scatter Plot--Wheat Price (US$): 1957-2002



Source: International Monetary Fund, International Financial Statistics, December 2002.

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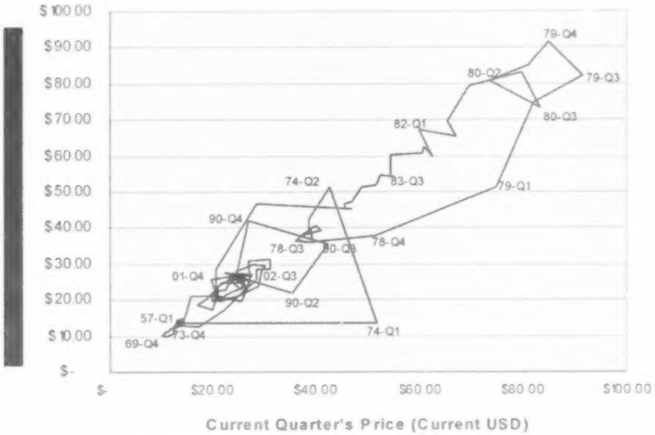
[16] For an example of the use of connected scatter plots to illustrate unemployment rate dynamics see Paul Ormerod, *The Death of Economics*, (London and Boston: Faber and Faber, 1994): pg 153-160.

A similar, but somewhat different, story emerges when one looks at a connected scatter plot for the real price of oil over the postwar period.

Figure 4. Connected Scatter Plot: Oil Price, Constant US Dollars - 1957 - 2002



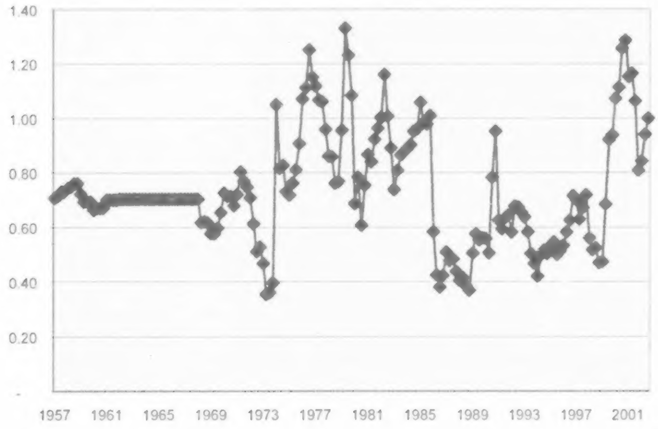
Source: International Monetary Fund, International Financial Statistics, December 2002.

In the figure, there is a heavy cluster of points in the bottom left which is the period of pre-OPEC oil price stability. Following the September 1973 OPEC-induced oil price spike, the trajectory zooms out and a new area of equilibrium appears to form at just below US$40 per barrel (in 2002:Q3 US dollars). The second oil price shock sent the trajectory soaring out to the US$85/bbl range and again some signs emerged of a new attractor having formed, but then the trajectory starts to move back towards the origin as the price of oil started its long trend decline. After a big loop at the time of the 1991 Gulf War, a new attractor point forms in the area of US$ 25/bbl, as OPEC succeeded in stabilizing prices with its stated intention to maintain prices in the US$22-28 range.

The problem lay in interpreting price signals. In this case, the misinformation was the appearance of new equilibria forming. Trend lines drawn through the peaks of the oil price spikes following the shocks of 1973 and 1979 made oil prices in the $60 dollar a barrel range look quite reasonable. The fact that the high-cost tar sands project born of that type of analysis was eventually mothballed is eloquent testimony to the scope there is to mis-read price data—and Canada did not lack for qualified economists or oil industry experts.

Perhaps most importantly, things came very much unhinged in terms of *relative* prices as well. For example, consider the price of oil in terms of gold. The data here are in index form with 1957:Q1=1.00. Through the Bretton Woods era, the comparatively stable prices of oil and gold resulted in the relative price between these two commodities moving in a rather narrow range. Following the breakdown of the Bretton Woods system, the relative price has not shown a coherent tendency to seek an equilibrium. And this surely is the essential problem: what matters in economics *is* the relative price.

Figure 5. Oil Price in terms of Gold, 1957 - 2002



Source: IMF, International Financial Statistics, December 2002.

In good measure, of course, the unstable price behaviour portrayed here was a reflection of inflation,[17] although the outburst of inflation that eroded the value of the US dollar was itself in good measure attributable to the break from the discipline which gold convertibility had previously imposed on domestic monetary and fiscal policies.

The period of maximum volatility was in the 1970s and early 1980s. Progressively, over the 1980s and 1990s, markets appear to have gained a better "handle" on the dynamics and contained the fluctuations to narrower margins. Hence the tighter ellipses traced out in the data as we move forward in time towards the present.

However, this is not to say that the international price fluctuations have been reduced to benign degrees. The late 1990s rise of the US dollar was accompanied by a decline in the price of gold and oil to very low values (see Figure below which show the prices of gold breaking loose from attractors that had governed price developments in the mid-1990s). This has prompted some analysts to characterize the conduct of US monetary policy as having been excessively tight.[18] US monetary policy is of course conducted with US economic conditions and domestic price stability in mind; nonetheless, given its role as the numeraire for international commerce, the implications of

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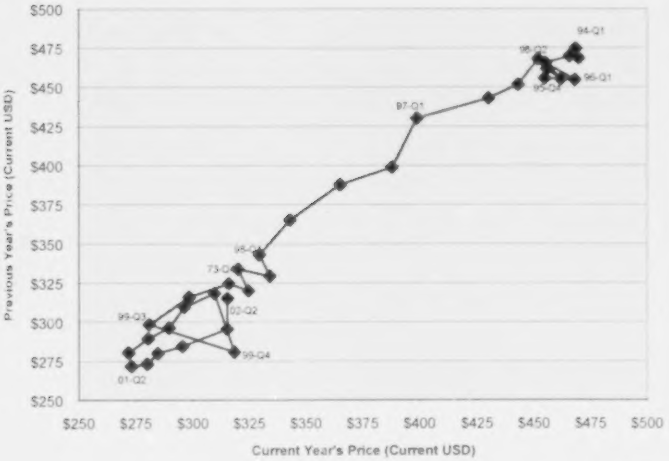
[17] Adjusting the series for the declining purchasing power of the US dollar muddies the water somewhat as the post-1972 trajectory comes back to overlap the pre-1972 attractor. However, the essential story is the same (and in a multi-colour graph equally evocative!). The trajectory of the nominal price is also of importance because it is after all the nominal price in which economic agents do their calculations in the real world, with all the attendant risks of money illusion which that entails.

[18] See, for example, the op-ed article by McGill University's Reuven Brenner, "Alan Goldspan", *Financial Post*, January 21st, 2003, pg 11. Brenner noted that after trading in the US$400 range in the period 1993-1996, the price of gold plummeted, trading as low as US$252.80 on July 20th, 1999. In Brenner's view, "Greenspan did not respond to the increased global demand [for dollars]; instead he brought about the disastrous currency fluctuations of the last six years." The article was stimulated by a renewed interest by the Federal Reserve Chairman in gold prices as an indicator for policy in a speech to the Economic Club of New York, December 19th, 2002.

US monetary policy run wide and deep. For example, Russia's financial crisis in 1998 was in part due to the collapse of oil prices; and Russia's crisis triggered Brazil's crisis.

Figure 6. Connected Scatter Plot: Gold Price – Constant US Dollars, 1994 - 2002



Source: International Monetary Fund, International Financial Statistics, December 2002.

Exchange Rate Instability

The regime change in the early 1970s is associated with more than the rise in commodity price volatility, however. Broader exchange rate volatility was also unleashed.

It is of particular relevance to the following discussion to contrast the solution to a savings-investment imbalance problem under the Bretton Woods regime versus under the ensuing system of generalized floating of the major currencies.

Under Bretton Woods, a savings-investment imbalance within a country resulted in a balance of payments problem that would have been addressed through liquidity support (well-known IMF facilities such as the SDR and the General Agreement to Borrow were developed in fact to provide such balance of payments support during the Bretton Woods era) or through an IMF-approved devaluation insofar as the balance of payments situation was viewed as reflecting an erosion of competitiveness, e.g., due to accumulated higher inflation in domestic costs and prices). Such a devaluation—for example that which was undertaken by pound sterling in 1968—would be spread uniformly over all trading partners, meaning that bilateral parities and price relationships between all other pairs of countries would be undisturbed.

By contrast, post-Bretton Woods, the brunt of adjustment to a balance of payments problem—whether the problem reflected an erosion of competitiveness or a domestic savings-investment imbalance stemming from policy choices—would be borne by the exchange rate. As well, the degree of exchange rate adjustment would be potentially much greater, since it could and routinely did involve overshooting for example. And thirdly, the devaluation would be asymmetrically spread over other currencies. By the same token, it would be larger for the limited number of currencies that shouldered the burden. And because of the differential movement against other currencies, the bilateral parities between other pairs of countries would also be affected. Insofar as countries that experienced disproportionate revaluations resorted to protectionist measures, the potential amplitude of exchange rate movement would be further expanded; and insofar as such countries were destabilized, there would be secondary shock waves emanating from an original disturbance.

The case for floating exchange rates is that they shelter countries from terms of trade shocks etc., facilitate adjustment of external imbalances, and in principle prevent the accumulation of inflation differentials that could subsequently lead to a disruptive exchange rate crisis.

Allowing that floating exchange rates actually fulfil these objectives for an individual country, how do they work for the system as a whole? After all, if one country adjusts to the impact of a terms of trade shock by devaluing, other countries face a revaluation from the same event. The possibility is obviously there for there to be knock-on effects such as a devaluation by an important trading partner. If a devaluation occurs in response to a domestically driven savings-investment imbalance that has little to do with domestic competitiveness *per se* (e.g., the imbalance is driven by the capital account, not the current account), exchange rate regime becomes a mechanism for externalizing a country's policy problems (e.g., a reluctance to raise incentives to save). It is not at all obvious that the system as a whole will function well.

And, indeed, the empirical record suggests that there have been generalized problems: exchange rate behaviour is one the areas of international economics where puzzles have emerged.[19] Three general features of the post-Bretton Woods exchange rate system have attracted researchers' attention: First, and perhaps most importantly, the large swings in the bilateral exchange rates linking the three major currencies (US dollar, yen and euro), the amplitudes of which are hard to explain on the basis of conventional theory. Second, there have discontinuous shifts of exchange rate parities, often large in magnitude, that have led to the formulation of theories of multiple equilibria. Third, there have been persistent divergence of currencies from the neighbourhood of their purchasing power parity.

Taking the issues in turn, it might be noted that the United States, Japan and the European Union together account for roughly 2/3 of global production and a sizeable proportion of total trade (both directly on a cross-border basis and indirectly through foreign affiliate sales). The exchange rates that link these economies are unquestionably three of the most important prices in the global economy. They affect not only the mutual competitiveness of enterprises in those economies but also of enterprises in other countries that are linked to these firms through foreign direct investment, as suppliers, or as direct competitors. More deeply, taking into account general equilibrium effects, they affect to some extent the relative prices of all other prices in the global economy. If these three currencies are mutually persistently far from equilibrium, by inference so is the global structure of prices.

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[19] For a discussion, see Dan Ciuriak, "Trade and Exchange Rate Regime Coherence: Implications for Integration in the Americas", *The Estey Centre Journal of International Law and Trade Policy*, Volume 3 Number 2, 2002: 256-274.

The theory of multiple equilibria has been developed to explain what appear to be sudden, unwarranted speculative attacks on currencies that have been performing quite well. It essentially holds that financial markets accurately anticipate a change in the policies that have supported the currency to date. In other words, if an inflationary future is implicit in the economic and political context facing a country, then financial markets precipitate the shift to the exchange rate to which that inflationary future would inexorably lead. Since the attack validates itself in the form a "self-fulfilling prophecy", for the theory to hold, the government whose currency is attacked must indeed follow through and adopt the inflationary policies, the anticipation of which led to the attack in the first place. The trouble with this theory is that governments of the attacked countries have not generally behaved as the theory requires—their policies have not become more inflationist. The result is that the exchange rate shifts tend to be real and to cause significant discontinuous changes in the relative competitive position of the country that is attacked and of course on its trading partners and competitors. At the same time, the currency risk attached to emerging market currencies has become so great that the effective cost of capital to borrowers in these countries has risen, affecting the relative prices of capital and labour.

The third puzzling aspect of exchange rate behaviour, persistence of divergence from purchasing power parity, also has implications for the information content of international prices. Insofar as they are large enough to create serious cost advantages/disadvantages that last long enough to affect producer decisions about how to organize production of goods and services in a context where cross-border fragmentation of the production process is eminently possible, such divergences can distort the international division of labour.

Taken together, these puzzling behaviours of exchange rates—and by implication the capital flows that play a large role in generating them—impart a considerable amount of noise into the international price system. In fact, given the magnitude of the effects, the noise would seem to be more than sufficient to compromise the quality of the "signal" that prices provide concerning efficient international organization of production.[20]

To consider the significance of these *de facto* features of the system of a floating exchange rate regime, it is useful to imagine first a world in which there is a rock-steady international numeraire and exchange rates adjusted only to offset differential rates of inflation in the various countries. In this world, a country which succeeded in doubling its real per capita GDP in terms of its own currency would also experience a doubling of its international purchasing power. Moreover, its growth in real per capita GDP would appear the same, *regardless of the vantage point from which one measured this growth—that is, whether from the perspective of an American, a Japanese or a European.*

In these terms, the picture of developments over the past several decades is one of remarkable instability.

For example, in terms of its own currency, Chile's per capita GDP was 55 percent of its 2001 level in 1970 and snaked up more or less steadily in real terms to its 2001 level. In constant US dollars, the picture is completely different. From this perspective, Chile's per capita GDP in 2001 was no higher than in 1970 and in the intervening years, it varied by as much as 60 percent higher and more than 40 percent lower. And in terms of constant yen and constant euros, the pictures are also dramatically different. Similar stories can be told for other countries.

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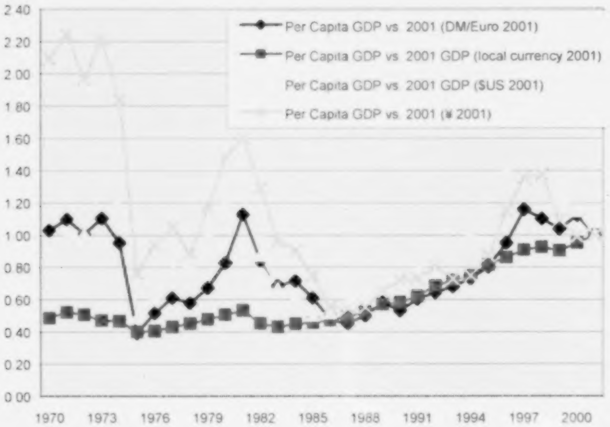
[20] In this regard, it might be noted that the price margins affected by trade liberalization in computable general equilibrium models, which are used to estimate the efficiency gains from trade liberalization, tend to be small compared to the magnitude of real exchange rate shifts.

Figure 7. Chile: Real Per Capita GDP in own-currency terms, constant US dollars, constant yen and constant DM/euros, 1970-2000



Source: International Monetary Fund, International Financial Statistics, December 2002.

The picture that emerges from consideration of income trends in common currency terms is not only a lack of convergence and considerable instability, it is one of *conflicting information*.

First, on the production side, instability in international purchasing power is associated with a roughly equivalent degree of instability in the international costs of the factors of production employed in individual economies—labour and land. Moreover, in countries that are dependent at the margin on foreign capital, there would also volatility in the relative price of capital compared to labour and land. Instability in factor prices affects decisions concerning where to locate internationally oriented production as well as choice of production technology, with downstream implications for capital-labour ratios, human capital requirements, wage and productivity levels. Since market economies generate production through self-organizing networks of inter-connected suppliers and customers, instability that disrupts parts of local networks can undermine the viability of whole networks. Difficulty and/or outright failure to organize export-oriented production severely constrains the ability to import, effectively sidelining the country from the perspective of the global economy.

Meanwhile, there are obvious social implications of instability in incomes that have implications of engagement in the market economy and by extension in the global market economy. At the core of all human social structures is the household. Formation of households, child-rearing and caring for elderly are all long-term processes that require a good deal of stability. For most households, the relationship to the wider society is mediated by income from economic activity. For households, instability in this relationship translates into risk. This risk is higher the lower the level of incomes and savings and the higher the debt. If prices and incomes in the international economy are more volatile than in the domestic economy, as appears to be the case, engagement in the globalized economy is riskier—and for those least able to weather sharp fluctuations in incomes, too risky.

The result would be transactions being largely between locals and at prices that move independently of global prices—the puzzlingly high "border effects" that characterize the global economy. The flip side of these effects in the poorest countries would be the observed "marginalization" of populations and "sidelining" of economies.

A significant amount of noise in the international price would seem a logical candidate as a systemic reason for the frustrating developmental failures of the past several decades. Indeed, the failure to invest in the specialized skills and capital required to participate in the global division of labour in the context of highly uncertain returns to such investment is directly analogous to the short-term structure of savings in countries with a history of high and variable inflation.

Concluding Comments

Economic development is hard. That clearly is the message of the centuries of large-scale divergence across economies. Catch-up growth is possible and has been accomplished at times. Price stability seems to be an important factor—certainly the evidence of convergence across US states and Japanese prefectures (and within the European Union) is fairly persuasive that trade, investment and technology transfer can turn the trick in a stable price environment. Episodes of convergence internationally appear to be correlated to the existence of exchange rate regimes that strengthen price signals.

We draw no policy conclusions here. Overall, history suggests that exchange rate regimes are particular to their historical setting, with important roles played by the political, security, and social context, over and above purely economic policy considerations. It is an open question of what is the feasible set of international exchange rate regimes for the current age. Perhaps the experience of the past three decades will allow nations and economic agents active in international markets to perform more effectively in the future. Certainly, there has been some diminution of commodity price volatility over the course of the past three decades. And it is possible that the use of techniques like inflation-targeting will help financial markets anticipate more accurately and reduce exchange-rate driven instability.

The point remains that there has been considerably more real price volatility under the current exchange rate regime than under the system which it replaced. A link can be drawn between that instability and the developmental failures that have contributed to the observed pattern of divergence that has characterized the most recent episode of globalization. And there is a policy conclusion from this: less emphasis should be put on the measurable characteristics of individual countries, certainly in a prescriptive sense when it comes to reforms.

Until proven otherwise, small and medium-sized economies must base their participation in the global economy on the presumption that exchange rates will tend to be persistently far from "equilibrium" valuations and that large-scale adjustments associated with (and indeed effected by) large shifts in the direction of capital flows will be the norm, rather than the exception. A safety first approach to participation in the global economy is thus eminently warranted: embracing trade, which provides the main benefits of globalization, but treating capital flows with great caution, and paying close attention to the international alignment of trade and financial links. Moreover, since shifts in international capital markets may be predominantly in reaction to developments abroad, it would be unwise to interpret a surge of inflows as endorsement of sound structural policies or sudden outflows as an indictment thereof. Structural reforms should be considered on their merit, not as possible solutions to international financial pressure.